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### New Rec: **Eastman Kodak** (EK \$43.23) September 14, 2001

**Position: Sell**      **Target: \$22**      **Timing: 2 (1=aggressive; 5=cautious)**

\$000,000	Q2 01A	Q3 01E	Q4 01E	2001E	2002E	2003E
<b>Revs</b>	3,592	3,440	3,535	13,542	13,583	13,393
<b>EPS\$</b>	1.12	1.02	0.95	3.63	3.21	2.17
<b>Y/Y%</b>	-33%	-27%	40%	-23%	-12%	-32%
<b>PE</b>				11.9	13.5	19.9
<b>PSR</b>				0.93	1.08	0.94
<b>Consens</b>		1.03	1.01	3.70	4.34	n/a

**Shares Out: 291 M**

**Market Cap: \$12.6B**

**FYE: Dec**

Summary: Eastman Kodak develops, manufactures and sells imaging products and services. Consumer Imaging accounts for about 53% of revenue and 54% of operating profit. Health Imaging is about 16% of revenue and 23% of profit. Professional and Other Imaging constitute the balance of revenue and profit.

Kodak management has led investors to believe that it can generate \$6B of free cash flow over the 2001-2005 time period. This is to be achieved mainly by an average of 5%-7% annual growth in revenue and profit in the Consumer Imaging business and by 6%-9% annual growth in revenue and earnings in Health Imaging.

Professional is supposed to grow in low single digits and Other Imaging is supposed to grow by 6%-11% on average.

In addition to generating higher operating profits, Kodak claims that it will be able to double inventory turns and cut DSO by about 8 days. The total impact of increased operating profits and better asset management in conjunction with a reduction in capital spending would, theoretically, yield the \$6B in free cash flow.

We have studied these various claims and assumptions. Our analysis concludes that the Consumer Imaging business should be unable to meet expectations. Analysts hope for 2%-4% growth for analog and 15%-25% growth for digital. The analog business has been declining. We think the problem is fundamental. Film use is declining due to the success of digital photography, and we expect the trend to continue. On the other hand, the digital business will prove to be far more difficult than expected for Kodak to navigate to profitability. Kodak's digital business will not enjoy the same market advantages, such as manufacturing scale, that it has enjoyed in analog film. We expect the Consumer Imaging business to be well shy of expectations, with an overall decline of about 2% next year, followed by accelerating declines through 2005.

While investors seem to have high hopes for the Health Imaging business, our research suggests that Kodak will suffer from the shift that is going on in the Health Imaging business away from analog film imaging and toward digital imaging. The company claims that it can successfully negotiate the shift, with only marginal gross margin impact. However, we doubt that declining film usage and declining film prices will be replaced by Kodak's digital health offerings. Kodak's digital health offering, now 50% of the segment revenue, is mainly the result of the purchase of Imation's medical imaging business in 1998. The main product is a dry imaging printer that uses dry film. However, the big growth area in digital health imaging products is PACS, (picture archive and communication system). With PACS images are kept and viewed digitally, which means that the need for dry film is obviated. Kodak's problem is that it does not appear to have a PACS offering that is able to compete with those sold by GE, Philips, Siemens, Agfa, Fuji and others.

We also expect the Professional segment and the Other Imaging segment to be shy of expectations, but this is just a side show relative to the size of the disappointment we expect in Consumer and in Health.

On the balance sheet side, inventory turn is currently about 5 times, and has historically been between 3 to 5.5 times. We have trouble understanding how it can go to 10 times. DSO is now 69. In the current environment, getting to 60 days will be very challenging.

In 2001 and in 2002 we expect Kodak to generate about \$400M in free cash flow in each fiscal year. The "street" expects \$600M-\$800M in 2002. Thereafter, however, is where we really part ways with the "street". We expect free cash to be a positive \$140M in 2003, a negative \$39M in 2004 and a negative \$234M in 2005, if the current dividend is not reduced. This free cash flow shortfall is driven

mainly by the failure of the Consumer Imaging and the Health Imaging businesses to meet revenue and profit expectations. We have included detailed cash flow projections through 2005 in our financial model at the end of this report.

The trigger to the beginning of a long decline in EK shares could come as early as Q4 of this year. We expect a disappointing holiday season followed by further earnings disappointments. We expect bulls to stop thinking that an economic turnaround will help. We expect that cash flow will become insufficient some time in 2004 to pay the current dividend. Based on our projection of \$2.17 EPS in 2003 and a reduction in the dividend in 2004, we set a target price of \$22 per share.

Rather than manage its legacy business to generate and retain maximum cash flow, Kodak management is investing in businesses in which it has no advantage. We think the result will be a decline in the value of Kodak.

#### Discussion:

Background: Kodak has four reported business segments: (a) Consumer Imaging, (b) Health Imaging, (c) Professional, and (d) Other Imaging (which includes document imaging, motion picture films, and consumer digital cameras and ink jet paper/hardware). Table 1 illustrates segment trends.

Table 1a – Segment Revenues (\$M)

	2000	1999	1998	1997	1996
Consumer imaging	7,406	7,411	7,164	7,681	7,659
Health Imaging	2,185	*2,120	1,526	1,532	1,627
Professional	1,706	1,910	1,840	2,272	2,367
Other Imaging	2,697	2,648	2,876	3,053	4,315
Total revenue	13,994	14,089	13,406	14,538	15,968

Table 1b – Segment Revenue Growth Rates

	2000	1999	1998	1997
Consumer imaging	-0.1%	3.4%	-6.7%	0.3%
Health Imaging	3.1%	*38.9%	-0.4%	-5.8%
Professional	-10.7%	3.8%	-19.0%	-4.0%
Other Imaging	1.9%	-7.9%	-5.8%	-29.2%
Total revenue	-0.7%	5.1%	-7.8%	-9.0%

\* Kodak acquired Imation's medical imaging business (\$500m annual revs) on 11/30/98.

Table 1c – Segment operating margins

	2000	1999	1998	1997	1996
Consumer imaging	15.9%	17.5%	15.1%	14.0%	17.3%
Health Imaging	23.0%	22.2%	21.0%	20.7%	23.0%
Professional	15.3%	19.6%	17.9%	12.5%	13.5%
Other Imaging	8.4%	7.4%	5.5%	-2.9%	4.3%

Table 1d – Segment operating profit as % of total

	2000	1999	1998	1997	1996
Consumer imaging	54.3%	55.5%	57.2%	67.6%	60.1%
Health Imaging	23.2%	20.1%	17.0%	20.0%	17.0%
Professional	12.0%	16.0%	17.5%	17.9%	14.5%
Other Imaging	10.5%	8.4%	8.3%	-5.6%	8.4%

1. The Consumer Imaging segment includes all consumer analog products, including film, paper, chemicals, photofinishing services and equipment, and digital/digitization products such as Picture Maker kiosks, Picture CD, and EK's online offerings. Consumer digital cameras, ink jet printers and paper, and scanners are included in the Other Imaging segment. Management's guidance is for 5%-7% average revenue and profit growth from 2000-2005, or 2%-4% for analog products and 15%-25% for digital. Table 2 includes the approximate revenue mix and profitability for the Consumer Imaging segment.

Table 2 – Consumer Imaging Segment Rev Mix and Margins – FY 2000

	Revenue mix	Oper Margin
Film	42%	25-30%
Processing	27%	0-2%
Paper	22%	14-16%
Digital	4%	-5%
Film cameras	3%	0%
Other	2%	0%

Source: OWS Estimates

We also estimate that the consumer digital products included in Other Imaging generated about \$750M-\$800M in revenue in 2000 and lost around \$100M-\$150M. EK has been attempting to transform its old economy film business into a new economy digital imaging business. We think it will be difficult to replace the profitability of film with profits from a digital model.

2. Consumer film volumes have been decreasing. Kodak's decline is dramatic and Fuji has recently taken share. Table 3 illustrates recent volume trends for the US market. EK and most analysts attribute the decline primarily to the economy. Opinions differ as to whether the volumes will trend up if an economic recovery should occur in the near future. The key variable is the growth of digital photography and the resulting impact on film demand.

Table 3 – Film Y/Y Volume Change (roll film &amp; SUC)

4 wks ending:	8/12/01	7/15/01	6/17/01	5/20/01	4/22/01	3/25/01
Kodak	-9.5%	-9.3%	-3.0%	-3.6%	0.6%	-6.3%
Fuji	15.0%	0.5%	-1.5%	0.6%	-3.6%	-4.3%
Industry	-1.7%	-5.7%	-2.5%	-3.8%	-1.1%	-5.5%
4 wks ending:	2/25/01	1/28/01	12/31/00	12/3/00	11/5/00	10/8/00
Kodak	-4.3%	-1.6%	-8.9%	-11.6%	-4.1%	-3.8%
Fuji	-3.9%	2.0%	-1.9%	-4.5%	7.6%	10.7%
Industry	-5.3%	-2.9%	-6.9%	-8.2%	-0.9%	-1.1%

Source: various "street" reports. Data excludes wholesale clubs.

We think catalysts are emerging which will accelerate the adoption of digital photography, and that film volumes will continue to decline as a result. These catalysts include:

a. Prices are falling rapidly for digicams: In the summer of 2000, entry level 2 megapixel (mp) cameras cost around \$600, whereas this summer they sell for \$250-\$300, and with more/better features. Entry level 3 mp cameras fetched \$800 last summer, while now they are selling in the \$450-\$500 range. (note: 2 mp cameras produce high quality 4"x6" and 5"x7" prints; 3 mp produces high quality 8"x10"s). The catalysts behind these declines are the widespread introduction of entry level devices aimed at the mass market, and heavy discounting on product transitions. Digicam vendors, including EK, are preparing to roll out a slew of new models at lower price points in time for the holiday season. Many analysts are projecting that digicam units will grow 40%-60% this year and 30%-35% for the next 4 years.

b. Flash memory prices are declining rapidly: Many digicams are sold with an 8MB memory card, which holds only a handful of pictures. Consumers typically upgrade the card to provide for greater capacity. Prices for memory were high in 2000, as demand greatly exceeded supply. However, the memory vendors, including Sandisk, Toshiba, and Hitachi, and Samsung, subsequently ramped too much capacity. Furthermore, retailers overestimated future demand, creating an inventory glut in the channels which is still being worked down. As illustrated in Table 4, prices have been in a freefall. Analysts are projecting sequential declines of 20% for ASPs in both Q3 and Q4 01.

Table 4 – Compactflash memory card street price trends

Street price	*Sandisk 1/1/01	Sandisk 9/11/01	% decline	Generic price 9/11/01
16MB	\$34	\$13	61.8%	\$13
32MB	\$64	\$28	56.3%	\$17
64MB	\$101	\$41	59.4%	\$26
128MB	\$202	\$75	62.9%	\$47
256MB (Type II card)	\$480	\$170	64.6%	\$109

\* Sandisk is the market share leader for Compactflash memory cards

c. A digital printing infrastructure is emerging: Until recently, consumers basically have had two options for printing hard copies of digital images – at home on an ink jet printer, or by downloading the images to an online processor. As we discuss later, neither of these options are well suited for the mass market, and penetration rates have been low. However, major chains are expected to begin rolling out digital minilabs within the next year, so that a consumer could drop off their memory card and come back in an hour to pick up their pictures. We think consumer awareness of this infrastructure could boost digital camera adoption.

3. Digicam penetration in Japan reached 15%-20% in 2000, and film volumes and prices there have been declining steadily. Digicam penetration in the US was 10% at the end of 2000, is projected to be 15%-18% by the end of 2001, indicating that a similar film peak could be near in the US (Europe, meanwhile, is projected to have about 8% penetration by the end of '01). In our opinion, the turning point for film in the US market could be the coming holiday season, when digicam

manufacturers and retailers will be heavily promoting mass market digicams. We project that US film volumes will continue to decline, despite expectations of a rebound.

4. Fuji recently doubled its US film manufacturing capacity, increasing industry wide US capacity by about 9%. The new capacity is primarily for 400 speed film, which is the fastest growing roll film and is where Fuji has lagged in terms of share. Fuji's US market share for 400 speed is approximately 18%-20%, versus its 28%-30% share for 200 speed. The \$300M project at its US plant in Greenwood, SC also added capacity for paper, medical film, and distribution. With Fuji already facing declining film volumes in Japan, its biggest market, we think Fuji will have difficulty absorbing the new capacity if volumes decline in the US. This raises the prospect of more price competition, particularly considering Fuji's history of pricing actions.

5. As US film unit volumes grew 15% in 1999 and 8% in 1H '00, during the height of the US economic expansion (versus the historical average growth rate of about 4%), EK also added manufacturing capacity. If US film volumes do decline, EK's options include (a) cut prices in an attempt to take or maintain share, (b) leave pricing as is, but at the expense of volumes, or (c) reduce capacity. We think a combination of options (a) and (c) is the most likely scenario, especially if Fuji becomes aggressive with pricing. Under any scenario, the implications for gross margins are negative.

6. Wal-Mart is rumored to be considering introducing private label (PL) film. Wal-Mart sells about 30% of all film sold in the US. The vast majority of its film sales are branded - Kodak and Fuji. Its entry level 35mm film has been supplied by Polaroid (not private labeled), but this relationship will likely end soon. Rumors are circulating that WMT will replace PRD's film with its own label, to be supplied by Fuji. WMT has already introduced a private label single use camera, and it has been making a significant push into private label across all of its categories. If WMT does make a push into PL film just as film may be nearing its secular peak, we think it could cause additional pricing pressure across the industry as all parties compete for a share of a shrinking pie.

7. Advance Photo System (APS) format camera sales are declining due to digital substitution. EK's Advantix brand APS film has dominated the market, and it currently represents about 15% of EK's film unit volume. While most of the growth has represented cannibalization of 35mm film, APS film carries higher margins so the shift has been favorable. However, US sales of APS cameras declined for the first time in 2000 to 2.7m units from 3.2m in 1999, while digicam sales almost doubled to 4.1m units.

Retailers tell us that whereas clerks previously had to "sell" the features of APS cameras to consumers otherwise considering 35mm, such efforts are now directed at the benefits of digital. APS film and developing is also more expensive than 35mm, and the features available with digital erode the basis for APS' premium. Shelf space previously dedicated to APS cameras is being reallocated to digital models, and camera makers are shifting R&D dollars from APS to digital.

Nonetheless, EK is bucking the industry trend by continuing to invest in APS, heavily promoting its recent roll out of the Advantix Preview camera which lets the user view an image on a digital screen before committing it to film. This camera must be expensive to make, but should find limited use.

8. A channel mix shift toward mass merchants hurts margins. The film market has been experiencing a channel mix shift toward mass merchant and warehouse club stores, where large amounts of film are sold in multipaks at discounted prices. Table 5 illustrates the mix in 2000. Wal-Mart alone sells 30% of all film sold in the US. We note that EK has sole supplier status for film at Costco, Sam's Club, BJ's Wholesale, so its mix is relatively more margin adverse than the industry mix.

Table 5 – Film channel mix – Industry FY 00

Mass merchant/discount	48.0%
Drugstores	29.0%
Supermarket	22.5%
Warehouse club	16.5%
Combo stores	15.4%
Dept store	5.3%
Camera specialty	4.9%

9. Photofinishing is a break even business for EK, and we think margins could turn negative as digital imaging grows. EK offers photofinishing services in the US through its Qualex subsidiary, and through Consumer Imaging Services in the rest of the world. We estimate that photofinishing services generated about \$2B in revenues in 2000, and no profit. "Street" analysts are projecting a slight downward trend for the top line, remaining around break even. The upside for Kodak is that the processing business allows it to produce more paper, increasing capacity utilization in a capital intensive manufacturing process.

Approximately 50% of revenue is from wholesale photofinishing. Qualex operates about 50 labs in the US which provide overnight photofinishing to 40,000 retail locations, representing about a 70% market share. The only other major player is Fuji, with about 26 labs and about a 20%-25% share. The other 50% of revenue is from Qualex's OnSite Pictures (OSP) service. OSP is primarily a turnkey solution in which Qualex provides the retailer with everything: equipment, paper and chemicals, service, handle environmental matters, training for the customer's employees, and a tech hotline. The retailer pays a flat fee or "click charge" of about 12-16 cents for each photo processed. Qualex serves 13,000 OSP retail locations. Its biggest customers are CVS and Walgreens, with about 3,000 OSP labs each, as well as Rite Aid, Eckerd and Target.

On-site processing grew in the 1990s at the expense of wholesale. This shift reduced barriers and transferred leverage to the retailers. Decreasing demand, underutilized capacity, and a more aggressive Fuji have eroded the profitability of wholesale. EK has scaled back on wholesale capacity, closing six of its labs this year alone. EK has tried to fill capacity by providing fulfillment for online processing (both in-house and third party), but so far the volumes have been insignificant.

In the near term, a big risk for EK is that film processing volumes continue to decline due to digital substitution, but digital output rates remain low and cannot replace the decrease in film volume (we discuss digital output rates in depth ahead). In a digital world, EK must make money from processing given the absence of film profits. As we discuss ahead, we think this will be challenging.

10. In digital imaging there is no consumable equivalent to film. EK must therefore derive profits from output and services. A key premise of EK's digital strategy is that digital imaging will catalyze growth in the volume of picture taking, and profits from the increased output will offset the loss of film profits. EK lost approximately \$150M last year on its consumer digital offerings, and losses in excess of \$100M are expected for 2001 and 2002. Cash flow from EK's traditional film business is supposed to fund its digital investments and losses, until the time when digital becomes self-funding. The following are the key aspects of EK's digital strategy:

Output – services and products:

1. Online photofinishing
2. Photofinishing fulfillment for third party online players.
3. Photo quality ink jet paper.
4. Provide retailers with turnkey digital minilabs for onsite processing.
5. Self-serve printing kiosks at retail locations

Other digital services and products:

6. Digital camera sales.
7. Digitization of film based images – Picture CD and Internet uploads
8. Digital services such as online storage and sharing.

11. We think online digital processing will represent only a small portion of total digital output. Online processing yields high gross margins. EK charges \$0.49 per print for online photofinishing, and we have heard estimates of costs ranging from \$0.04-\$0.10 per print. By comparison, retailers typically charge about \$0.29 per print for on-site film processing, of which EK gets between \$0.12-\$0.16. If volumes were to grow, online processing would represent a significant profit opportunity, since it would allow EK to bypass the retail middleman. Importantly though, EK must be careful to avoid burning its relations with its retail customers who may perceive EK's online initiatives as a threat to their photofinishing business.

Adoption rates for online processing have been extremely low. In 2000, the total industry photofinishing revenue for digicam uploads was \$12M, or less than 0.25% of the photofinishing market. Of the 85% of digicam users that actually print their images, around 95% opt to print at home on an ink jet printer. Current estimates are that online photofinishing will grow to \$300M by 2006, but even if it happens this will still represent only about 6% of the market.

Insiders and analysts point to the following reasons for the low rate of adoption: (1) broadband is virtually required for uploads, and broadband penetration is too low (2) ease of use - many consumers are uncomfortable with

digicams and the upload process. Approximately 60%-75% of the online photofinishing market is actually for mailed and scanned film captured images. Furthermore, many subscribers to online photosites simply use the storage and sharing functions, which are typically free. Ofoto has stated that of those consumers who do upload pictures to its site, only 45% actually turn into paying customers.

Online photofinishing is also a crowded field. At one time there were over 100 online photosites. After the shakeout, only ten or so remain, but these have strong brands and relatively large membership bases. While we think the pure plays will have a hard time making on their own, they could still drive pricing down on their way out. Click and brick retailers represent more significant competitors. Wal-Mart offers online photofinishing for \$0.26 per 4"x6" print (Fuji provides fulfillment), compared with \$0.49 for Kodak.

Furthermore, EK has lowered the barrier to entry by providing a turnkey photosite infrastructure (e.g. Kodak Picture Center at CVS.com) and fulfillment services to retailers such as CVS, Rite Aid, and Kmart. While the benefits to EK include increasing capacity utilization and stimulating growth in digital imaging, the cons are that EK must share any profits with its retail partners and it creates competition for its own online efforts.

12. Microsoft Windows XP may be a roadblock for EK's digital strategy. When a Kodak Easy Share camera is docked with a Windows PC, Kodak's photo software launches. With this software, a user can edit and e-mail images, and connect to Prints@Kodak to order prints. However, Microsoft has designed the forthcoming Windows XP operating system such that first a menu appears listing photo applications from Microsoft, Kodak, and third parties. Furthermore, the operating system will steer orders for prints to Microsoft's online photofinishing partners which will pay to be listed in Windows, and which will also pay Microsoft a fee for each photo printed. This system actually reflects a compromise between Microsoft and Kodak to alleviate an even more onerous design for EK in earlier versions of XP, as has been well publicized. While XP is subject to further change, the current system would be a significant impediment to EK's strategy, in our opinion.

13. We think the market for ink jet paper will be small, while the competition is intense. While about 80% of digicam owners print at home, they only print 10%-15% of their images. We estimate EK's ink jet paper revenues in 2000 were \$60M-\$70M. We've seen estimates that the market for photo ink jet paper is growing at 40%-60% and could reach \$300M-\$500M by 2005. However, we think ink jet printing will be ill suited for the mass market. Problems include:

- a. The printing process is slow. It can take up to an hour to print 24 quality pictures, making home printing impractical for more than a few photos.
- b. Home printing costs more. The cost to print a quality 4"x6" photo at home ranges from \$0.80-\$1.00, factoring the paper, ink, printer amortization, and cost of mistakes. The paper alone costs around \$0.45 per sheet. By comparison, Ofoto.com charges \$0.49 while Walmart is \$0.26 for a 4"x 6" print.

c. The quality is less than retail/online photofinishing, and mistakes are common.

The paper market is crowded, and barriers to entry are low. The printer companies are private labeling paper from Konica, Agfa, etc, and their strong brands enable them to compete with EK. In 2000, EK was the market share leader for ink jet paper, but it has since lost that position to Hewlett Packard. EK lost further share in Q2 01, but managed to hold onto the number 2 position. Other competitors include Epson, Canon, Burlington Paper, and International Paper. Sony has announced that it will enter the photo printer market by year end.

Furthermore, if EK is unable to de-couple the paper from the printer, its addressable market will be constrained. Different inks react differently with different paper, so HP paper generally works best with an HP printer, and the same is true with Epson, etc. Additionally, the printing companies make their profits on the consumables, not the hardware, so they have an incentive to protect their share.

14. Photo kiosks will be a competitive, niche market. EK's Picture Maker kiosk is a self-serve machine capable of printing images from CDs, memory flash cards, the Internet, and hard copy prints. They are primarily located at drug, food, mass merchant, and photo specialty stores. EK sells or leases the machines for about \$17K-\$20K each, on which it turns a profit, and each kiosk generates another \$6K or more in annual revenues for paper and ink consumption. At the end of Q2 01, EK had 31,800 units installed worldwide, a 23% increase over the 25,800 installed as of the end of Q2 00. The installed base in North America is projected to grow from 26,000 units in 2000 to 150,000 by 2006, according to one estimate, and penetrate new channels such as convenience stores.

We think kiosks are ill suited for the mass market. It takes far too long to print the equivalent of a roll of film, so we think volume will be modest. Indeed, about 75% of kiosk transactions are enlargements or simple reprints. While Kodak has heretofore been the leader in units installed, there have been many new entrants in the past couple of years. Competitors now include Fuji, Agfa, Pixel Majic, Telepix, Photo-Me, and Sony. Eckerd recently bought 1,200 kiosks from Pixel Majic, which they chose over EK's Picture Maker.

15. We think most digital printing will be done on-site at retail minilabs, where EK historically has had difficulty generating profits. The minilab vendors – Fuji, Noritsu, Gretag, Agfa, Konica, and France based Photo-me – are rolling out digital minilabs at price points significantly below the price at which most analog minilabs have traditionally sold. These machines have smaller footprints and generally cost less to operate than analog minilabs, which makes them attractive for retailers. Vendors also offer low priced digital modules which can be added to a legacy analog minilab to create a hybrid. An industry expert with whom we spoke indicated that virtually all of the major chains in the mass merchant and food and drug channels are planning to transition their on-site labs to digital, so that consumers would give their memory card to the clerk and come back in an hour for their pictures. Wal-Mart is installing Fuji digital minilabs in all of its new stores, and EK's Qualex has purchased hundreds of Photo-me digital minilabs for its OSP program.

EK's CEO acknowledged on the Q2 01 conference call that he, too, believes the majority of digital printing will be done at retail. Consumers are accustomed to retail photofinishing, and one hour service has been tremendously successful. The problem for EK is that its retail photofinishing services have not been making money. Achieving profitability in a digital market will arguably be even more challenging for EK, given that retailers will have more options. Kodak will still sell paper, but margins in that category have also declined significantly over the past five years as Fuji has become more aggressive and as retailers have gained leverage.

16. If digital output rates remain low as film volumes continue to decline, as we expect, a profit gap could result. EK's ability to replace declining film profits with digital output profits is dependent not only on the growth in volume of images captured, but also on a high rate of hard copy output. However, in 2000 only 10%-15% of digital images were printed. In our opinion, output rates will continue to be low in the near future for the following reasons:

- a. Current output options (primarily online and home inkjet) are not yet convenient and easy to use. In our opinion, retail minilabs will fill this void, although the rollout could take a year or more.
- b. Digicam features such as the ability to preview, edit, and share images are among the primary reasons consumers choose to go digital. In our opinion, this satisfaction with the soft copy means digicam users will not necessarily want a hard copy print.
- c. The "delete/select effect." According to a study by the Photo Marketing Association, digital camera users delete 42% of images captured, and print only 25% of those which are saved, yielding a 15% output rate. In contrast, with film the consumer typically prints the entire roll, including errant or duplicate images.

We think the last two points indicate inherently lower print rates for digital as compared with film. Compounding EK's problems is that there will be many formidable competitors fighting for a share of this output, which could depress the profitability of output in the first place.

17. The digital camera market is very competitive, and EK's execution has been flawed. EK's Easy Share system includes a digicam and a docking station with photo software which lets users easily transfer images to a PC and connect to EK's Internet photosite. During 2000, EK was reportedly losing money on the manufacture of digicams, due to low volumes and sourcing issues which it is attempting to address. Still, we estimate that EK could lose \$75M or more on the sale of digital cameras in FY 01. Without a consumable, EK must either make money on the camera or on output.

We think it will be difficult for EK to make money on the sale of the digicam. The barriers to entry are low, both from a capital and technological perspective. EK no longer competes with just imaging companies, but also with consumer electronics companies such as Sony and computer/networking companies such as Hewlett Packard. These companies are used to competing in

markets with short product life cycles and in thin margin environments, while EK is not. Sony and Olympus are the market share leaders for digicams, as illustrated in Table 6. These players are strong in the consumer electronics channels, where EK is relatively weaker

Table 6 – Digital Camera Market Share

<u>Volume (units sold)</u>			<u>Dollars</u>		
4 wks ending:	7/8/01	8/4/01	4 wks ending:	7/8/01	8/4/01
Sony	35.7%	33.2%	Sony	44.2%	43.1%
Olympus	20.1%	18.4%	Olympus	22.3%	20.8%
HP	11.2%	14.3%	Canon	9.5%	9.2%
Kodak	12.7%	11.5%	Kodak	9.5%	8.6%
Canon	8.4%	7.8%	HP	7.0%	8.6%
Fuji	2.6%	2.4%	Fuji	2.0%	1.9%

Source: various “street” reports

One of EK’s objectives with Easy Share is to “attach” digicam users to EK’s output infrastructure –primarily its online service, which as we discussed appears to be a small, competitive market. To make matters worse, recent reports indicate that only 50% of people who purchase an Easy Share camera are also purchasing the docking station, which will negatively impact any attachment rate.

18. Digitization/digital services will not generate significant profits. Digitization primarily refers to scans of film images to Kodak Picture CD and Internet uploads (e.g. to EK & AOL’s “You’ve Got Pictures”) which consumers can order for a fee when dropping off film for overnight development. These efforts have largely failed. The percentage of rolls processed by Qualex which have been scanned/uploaded has hovered around 4%-5% for more than a year. We expect these services to flounder as digital camera usage increases. EK’s “value added” digital services relate primarily to storage and sharing services offered through its array of online photo sites. Consumers are accustomed to getting these services for free, and there’s been little indication that people are willing to pay for them.

19. Health Imaging (HI) is supposed to be an important growth area for EK, with guidance for 6%-9% CAGR for 2000-2005. Historically, EK primarily sold sensitized film and chemicals to hospitals and imaging centers, yielding relatively good margins. However, digital imaging systems are cannibalizing analog products. Industry sources estimate that medical analog film volumes for the industry have ranged from flat to mid single digit declines for the past five years, and this downward trend is expected to accelerate. Therefore, EK has expanded its offerings to include digital imaging equipment and related services. It now competes in a space with industry giants GE, Philips, and Siemens, plus Fuji and Agfa and many new competitors. This is a crowded field. Table 7 illustrates the approximate market size and growth rates for each category in the medical imaging market:

Table 7 – Medical imaging market

	Market size (\$M)	Growth Rate
Analog X-Ray	700	Single digit declines
Specialty (e.g. dental, mammography, etc)	325	5%
Digital imagers & media (dry and wet)	750	8-12%
CR/DR digital x-ray capture equipment	550	15-20%
Picture archive and capture systems (PACS)	700	30-40%

Source: "Street" reports

Table 8 illustrates EK's product growth in Q2 01.

Table 8 – Q2 01 Y/Y growth by product category

Analog products:	Y/Y
Analog (excluding specialty film)	-10.0%
Specialties:	
Dental	1.0%
Mammography & oncology	9.0%
Total analog	-4.0%
Digital products:	
Dry laser printers	19.0%
Film for dry laser printers	37.0%
X-Ray Capture and PACS	Over 100.0%
Wet laser printers	*
Total digital	18.0%
Total for segment	6.0%

\* EK didn't disclose % decline. Product is being cannibalized by dry printers.

We estimate that digital products comprise about 50% of HI's current revenues. Offerings primarily include dry laser printers and media, x-ray capture equipment, and picture archive and communication systems (PACS). Dry laser printers and media have been the biggest sellers, although PACS and x-ray capture equipment are growing the fastest. EK says that the margin impact from the transition away from paper to digital should be limited, perhaps a negative 1% per year until the product volumes hit a critical mass. However, as table 9 illustrates, margins have recently been declining rapidly. This is mainly due to price pressures on analog and digital products.

Table 9 – Health Imaging Revs and Operating Margins (\$M)

	Q2 01	Q1 01	Q4 00	Q3 00
Revenue	586	561	581	534
Oper margin	16.7%	19.3%	21.2%	25.8%
	Q2 00	Q1 00	Q4 99	Q3 99
Revenue	553	534	571	503
Oper margin	23.3%	22.1%	22.1%	23.3%

20. It is important to understand that the most significant growth area in medical imaging is PACS. We recently attended the American Healthcare Radiology Administrators (AHRA) trade show in Las Vegas, and the PACS exhibits were the biggest draw. PACS are digital image management systems which facilitate

presentation, communication, and storage. PACS enable hospitals to go filmless, with resulting cost savings from the elimination of film, chemicals, and archive personnel. Lost film has also been a big problem for hospitals, with loss rates ranging from 5%-25%. The biggest benefits of PACS, however, are (a) improved service to referring physicians and patients, and (b) productivity gains from the redesign of workflow and processes. The improved service and higher throughput capacity give radiology departments a competitive advantage which can allow them to grow their practice through share gains.

PACS are integrated systems, comprised of software, servers, archives, workstations, modality interfaces, digital x-ray equipment, a high speed network, and workflow design. Digital images captured on x-ray, MRI, CT scanners, ultrasound machines, etc. are sent to PACS servers, which route them to local workstations or to referring physicians via the Internet, and later archive them. Vendors include GE, Philips, Siemens, Marconi, Agfa, Fuji, Kodak, and several startups. The vendor will often do the systems design and integration work, although many hospitals hire independent consultants. The key differentiators are the software, platform, and design and integration expertise. Implementations can span several years, and costs can be \$2M-\$5M or more a full system.

PACS penetration at US hospitals is approximately 8%, although it is estimated to be 15%-20% by 2003. Industry insiders estimate that 40% of the 5,000 hospitals in the US are in the evaluation process. Penetration at independent imaging centers lags hospitals. Most of the emerging markets are still analog.

21. Kodak's PACS offering appears to be inferior to the industry leading systems. Based on our conversations with top radiologists and with all of the major medical imaging players at the AHRA trade show, we think it is clear that Kodak's PACS offering lags behind the industry leaders. These sources tell us that EK's technology is five years behind the leading systems. The industry consensus was that EK has not been committing sufficient resources to its medical imaging business, especially its digital products.

EK's PACS was developed by Cemax-Icon in the mid 1990s. Imation had acquired Cemax-Icon in 1997, before selling it to EK in late 1998 along with the rest of its medical imaging business. Industry insiders say that EK hasn't made many significant improvements to the technology since acquiring it. These sources indicate that "brain drain" is likely a factor, meaning that key developers of the PACS may have moved on as the technology has changed hands. Indeed, former Cemax-Icon execs started Stentor, a start-up firm with an innovative web communication application for PACS.

There are two basic approaches to PACS implementations – turnkey and best of breed. Turnkey implementations have been more popular. If an institution wants to do a turnkey implementation, we think that Kodak is at a competitive disadvantage to the modality vendors (GE, Philips, Siemens), who have much broader offerings and more experience with systems implementations. If EK is unable to get turnkey projects, it limits the company's addressable market for digital x-ray capture equipment as well.

In a best of breed implementation, EK is also at a disadvantage, because none of its products are industry best. Industry insiders say that Kodak has good digital x-ray capture equipment, but its products do not have any distinguishing features which put them ahead of the pack. With respect to dry laser printers, market participants say that EK also has a good printer, but not any better than Agfa's.

For the PACS itself, while there is mixed opinion on who is best, consensus appears to be that Kodak is one of the worst. A prominent radiologist tells us that Agfa and GE are in a league of their own. A customer survey of 8 PACS vendors by healthcare consulting firm KLAS ranked Philips, DR Systems (a startup), and GE as the top three. Kodak finished seventh. Fuji's newest PACS created a lot of interest at the trade show. We spoke with one Boston area hospital which raved about Fuji's PACS and which said Kodak's offering was far inferior to the others they looked at.

22. Digital X-Ray Capture has been a fast growing part of the business. There are two technologies for digital x-ray capture – computed radiography (CR) and digital radiography (DR), and Kodak offers both. Sources indicate that CR/DR penetration at hospitals is less than 15%, and lower at imaging centers. CR is a cassette based technology which constitutes the vast majority of the current market for digital x-ray capture. Fuji dominates the CR market with share estimates of 70%, although a top radiologist tells us that Agfa currently has the best product on the market. We think EK's sales of CR units will slow as PACS vendors increasingly bundle digital x-ray in turnkey PACS implementations. Prices for CR have been in decline, and we think this has contributed to the recent decline in Health Imaging's margins.

DR is a fully digital technology which is more efficient and offers higher quality than CR, but the capital costs are much higher and the market has been slow to materialize. Entry level CR machines begin at about \$60K, while DR generally begins around \$200K. GE has approximately 55% of the installed based, and other competitors include Siemens and Canon.

23. EK's dry laser printer business has also grown well. Dry imaging is the successor technology to wet laser printers, which have been used for years to print from MRI, CT, ultrasound, and standalone CR x-ray. In a non-PACS environment, printing from these modalities is a necessity. The dry printers use a single emulsion film which is vendor specific. This film is more expensive than traditional double emulsion analog film, and provides bigger margins. The printers themselves are a low margin product. Growth in dry laser film has generally offset the decline in analog film over the past 5 years. Market participants tell us that Kodak and Agfa each have 40%-45% of the market, with Fuji getting most of the rest.

Although growth in PACS and CR/DR implementations will drive some sales of dry laser printers, the trend will be away from printing since digital storage capability means a hard copy will no longer be required. PACS implementations will not mean that hard copy prints will go away completely, since many

physicians will still want a hard copy because it is portable, while others will use hard copy until they get acquainted with soft copy diagnosis and the intricacies of the new PACS.

However, industry insiders tell us that hospitals with fully implemented PACS typically experience hard copy print rates of 25% or less. Further, these insiders say this rate is expected to decline primarily because: (a) the efficiencies and diagnostic tools afforded by soft copy represent significant advantages over hard copy diagnosis, and (b) one of the main reasons for implementing PACS is to save on film costs, so there will likely be administrative pressure to decrease hard copy printouts.

24. As PACS and CR/DR implementations grow, traditional analog film should experience increasing pricing pressure and overcapacity. Industry experts note several catalysts for the accelerated adoption of PACS and CR/DR, including significant advancements in: (a) high speed data communications networks, which are necessary for the rapid transfer of the large data files (b) high resolution and luminance monitors, which provide for higher quality images than film (c) servers, workstations, and other computer hardware, and (d) web communication applications. Industry sources indicate that falling prices and increasing rates of capital expenditures by hospitals will also help drive PACS sales.

Sales reps tell us that analog medical film prices have fallen precipitously over the past five years. EK has told investors that film prices fell 5%-7% in 2000. We think that EK's recently renegotiated contract with Novation has triggered even further downward pressure on pricing, as we discuss next. Meanwhile, Fuji just recently added manufacturing capacity for medical film in its US plant at Greenwood, S.C. EK manufactures most of its film at its giant US plants in Rochester, NY and Windsor, CO. While this capacity can be used to manufacture film for dry imagers, we think that the growth of digital film will not keep pace with the rate of decline for analog film, as we discuss further ahead. We think the convergence of falling prices and potentially lower capacity utilization levels could erode margins even further.

Industry sales reps tell us that Kodak aggressively pursues contracts with group purchasing organizations (GPOs). Kodak recently renegotiated its contract with Novation, a GPO for over 2,000 care centers. The \$1.4B, 5 year deal primarily covers film and dry imagers. Sources indicate that Kodak's bid was effectively 20% or more below prevailing market prices. Renegotiations of big GPO contracts tend to catalyze downward pricing pressure for film throughout the industry. An independent hospital getting 50% off the list price of film can bring that discount up to 70%-80% off list by participating in a GPO negotiated contract. Approximately 75% of all expenditures for health care supplies and equipment are now made under agreements negotiated by GPOs. Kodak partially attributed the margin decrease in Q2 '01 to sales made under the Novation agreement.

25. Digital substitution has had the biggest impact on EK's Professional segment, which represents about 12% of revenue. EK is projecting 1%-3% revenue and profit growth over the next 5 years, but most analysts are projecting mid-single

digit declines. Professional has three units, commercial, graphics, and portrait. In the commercial business, film and paper sales to news media and commercial photography businesses (e.g. catalogue, advertising, etc.) are declining as these users are switching to digital cameras at an accelerating pace. In graphics, computer-to-plate (CTP) technology is cannibalizing the traditional process of using offset plates, which requires film. Finally, digital substitution has progressed more slowly with portrait photography (e.g. school, studio), but revenues have been declining due to the economic downturn. We project mid-single declines in revenues and high single digit declines in profits for Professional through 2005.

26. We estimate that the Other Imaging segment will grow at a rate of 5%-6% through 2005, which is at the low end of analyst expectations and at the low end of EK's guidance. Document imaging, 4% of revenue, primarily represents sales of microfilm/microfiche products and services. This is a declining business which will be milked for cash. Entertainment, 7% of revenue, represents the sale of motion picture film. The move from analog to digital has been slow in the entertainment world, and EK projects this segment will grow at a rate of 1%-3% through 2005. Government/commercial imaging consists primarily of the sale of film, optic devices, and services to the military and other government institutions. EK projects growth of 12%-16%, but the unit represents just 3% of sales. Finally, Other Imaging includes consumer digital cameras, scanners, ink jet paper, which we analyzed in conjunction with EK's other consumer businesses.

27. CASH FLOW. EK is projecting \$6B in free cash flow after dividends in the 2001-2005 period. Table 10 illustrates EK's projections. The primary drivers of EK's plan are (a) projected average revenue and earnings growth of 5%-7%, (b) reduction of capex to \$800M per year, (c) working capital improvements driven by a doubling of the inventory turn rate and a reduction of A/R DSO by 8 days.

Table 10 – EK's cash flow projections (\$B)  
2001-2005

Net earnings	6.8
D&A	4.0
Change in Inv/AR	0.9
All other	0.5
Capex	(4.0)
Option exercises	0.4
Dividends	(2.6)
Total	<u>6.0</u>

EK intends to use this cash for the following initiatives:

a. Debt reduction – EK has promised investors that it will reduce its debt/capital ratio to the high 30%'s by the end of FY 02. We calculate that this will require more than \$1B. Table 11 below illustrates the rising debt/capital trend.

Table 11 – Debt/Capital (\$M)

	12/31/96	12/31/97	12/31/98	12/31/99	12/31/00	6/30/01
Debt	1,100	1,196	2,022	2,099	3,372	3,849
Equity	4,734	3,161	3,988	3,912	3,428	3,261
Debt/total capital	19%	27%	34%	35%	50%	54%

- b. Acquisitions – Likely targets include Health Information Systems and professional printing. Acquisitions are EK’s first priority for uses of cash.
- c. Internal development – In addition to incremental capex, EK is reportedly planning to establish a JV to manufacture OLED’s used in displays for cell phones, etc. EK holds most of the key patents for this technology, and currently licenses the technology to various competitors.
- d. Share buybacks – EK suspended its buyback program in Q1 01 after spending \$4.7B over the past 6 years. Repurchases are EK’s lowest priority.

Analysts expect \$300M-\$400M in free cash after dividends for 2001 and \$600M-\$800M for 2002, so the \$6B target is heavily back end loaded. It would also represent a significant turnabout from the performance of the past 5 years, which is illustrated in Table 12 below.

Table 12 – Free cash flow after dividends 1996 – 2000 (\$M)

	12/31/96	12/31/97	12/31/98	12/31/99	12/31/00	5 year total
Cash flow from operations	2,484	2,080	1,483	1,933	982	8,962
Capex	(1,341)	(1,485)	(1,108)	(1,127)	(945)	(6,006)
Free cash	1,143	595	375	806	37	2,956
Dividends	(539)	(567)	(569)	(563)	(545)	(2,783)
Free cash after dividends	604	28	(194)	243	(508)	173

We think EK will miss its \$6B target. Table 13 illustrates our projections. The most significant shortfall should be due to earnings. We project a declining trend in earnings, for total earnings of \$3.2B from 2001-2005, versus EK’s projection of \$6.8B. We project that the dividend will be reduced by 2004.

Table 13 – OWS’s projections for free cash flow (\$M)

	2001	2002	2003	2004	2005	5 yr total
Net income	1,056	939	639	408	207	3,249
D&A	900	800	800	800	800	4,100
Changes in working capital	(35)	(12)	19	72	81	0
Cash payment from restructuring	(200)	0	0	0	0	0
Cash flows from operations	1,721	1,727	1,458	1,280	1,087	7,273
Capex	(800)	(800)	(800)	(800)	(800)	(4,000)
Free cash	921	927	658	480	287	3,273
Dividends	(513)	(516)	(517)	(250)	(250)	(2,046)
Free cash after dividends	409	411	140	230	37	1,227

Table 14 illustrates EK’s projections for the revenue growth which it believes will drive earnings. Table 15 illustrates OWS’ projections. We think gross margins will come under pressure in all segments, with pricing and share under pressure as EK shifts from high margin analog businesses to thin margin digital markets, and as capacity utilization in its film and paper factories declines.

Table 14 – EK’s Projections for Revenue Growth Rates by Segment 2001-2005

Consumer imaging	2.5 - 5%
Health Imaging	6 - 9%
Professional	1 - 3%
Other Imaging	6.5 - 11%
Total	5 - 7%

Table 15– OWS’ Revenue Growth Projections by Segment

	2001	2002	2003	2004	2005
Consumer imaging	-6.4%	-1.9%	-4.0%	-6.0%	-5.5%
Health Imaging	6.0%	3.4%	1.0%	-1.0%	0.0%
Professional	-9.8%	-5.1%	-6.0%	-6.0%	-6.0%
Other Imaging	2.0%	6.3%	5.0%	5.0%	5.0%
Total revenue growth	-3.2%	0.3%	-1.4%	-2.2%	-2.4%

We also think EK will have difficulty reducing inventory and AR by almost \$1B. EK’s inventory turn rate was 5.1x in 2000, and ranged from 3.1x –5.6x during the 1990s. Given the other challenges that EK will be facing, we think achieving such a dramatic improvement in turns will be difficult. EK did reduce inventory by \$267M in Q2 01, but \$57M was a write-down and the remainder represented primarily a reduction of bloated stock levels, and similar reductions should be difficult. We project that the turn rate will improve to 5.5x by 2005. Likewise, we think reducing DSO by 8 days will be difficult given the current economic trends, with customers likely stretching payments. DSO has ranged from 67-77 days over the past six quarters, and EK is targeting the lower 60s. We project DSO will remain in the high 60s.

We think EK will be able to generate a modest amount of cash over the next two years by simply stabilizing inventory/AR and reducing capex. However, we project cash flow will steadily decline thereafter, putting at risk EK’s plans for reducing debt and growing its businesses through internal and external investments. Our projections indicate cash flow may be insufficient to provide for the current dividend as early as 2004, at which point EK would be faced with the unattractive option of either increasing debt or cutting spending even further to provide for the return.

We think EK could begin to miss earnings and/or continue to reduce forward guidance as soon as Q4 01, and that this will be the indicator to investors that its future expected cash flows are in jeopardy. In our opinion, the primary factors negatively impacting Q4 include (a) increased mass market demand for digicams during the Holiday season, at the expense of film and paper consumption, (b) pricing and share pressure for film, based on Fuji’s recent actions and the continued ramp of its new capacity, and (c) continued margin pressures in health imaging, particularly with medical films as Fuji ramps capacity in that area as well.

## 28. Financial projections

	3/31/01	6/30/01	9/30/01	12/31/01
Sales	2,975	3,592	3,440	3,535
Cost of Sales	1,898	2,189	2,102	2,206
Gross profit	1,077	1,403	1,338	1,329
Amort. of goodwill	42	37	37	37
SG&A	574	629	600	615
R&D	189	186	195	200
Operating income	272	551	506	477
Interest Expense	61	58	57	56
Other	23	(7)	0	0
IBIT	234	486	449	421
Tax	77	161	153	143
Net inc bef charges	157	325	296	278
EPS bef charges	\$0.54	\$1.12	\$1.02	\$0.95
Charges (after tax)	7	289	0	0
Net income	150	36	296	278
EPS	\$0.52	\$0.12	\$1.02	\$0.95
Shares	290.5	291.3	292.0	292.0

% of Revs	3/31/01	6/30/01	9/30/01	12/31/01
Sales	100.0%	100.0%	100.0%	100.0%
Cost of Sales	63.8%	60.9%	61.1%	62.4%
Gross profit	36.2%	39.1%	38.9%	37.6%
Amort. of goodwill	1.4%	1.0%	1.1%	1.0%
SG&A	19.3%	17.5%	17.4%	17.4%
R&D	6.4%	5.2%	5.7%	5.7%
Operating income	9.1%	15.3%	14.7%	13.5%
Interest Expense	2.1%	1.6%	1.7%	1.6%
Other	0.8%	-0.2%	0.0%	0.0%
IBIT	7.9%	13.5%	13.1%	11.9%
Tax	2.6%	4.5%	4.4%	4.1%
Net inc bef charges	5.3%	9.0%	8.6%	7.9%
Charges (after tax)	0.2%	8.0%	0.0%	0.0%
Net income	5.0%	1.0%	8.6%	7.9%

	3/31/02	6/30/02	9/30/02	12/31/02
Sales	3,003	3,565	3,460	3,555
Cost of Sales	1,904	2,242	2,180	2,257
Gross profit	1,099	1,323	1,280	1,298
Amort. of goodwill	37	37	37	37
SG&A	570	620	600	620
R&D	200	200	200	200
Operating income	292	466	443	441
Interest Expense	60	60	60	60
Other	0	0	0	0
IBIT	232	406	383	381
Tax	77	134	126	126
Net income	156	272	257	255
EPS	\$0.53	\$0.93	\$0.88	\$0.87
Shares	292.3	292.5	292.8	293.0

% of Revs	3/31/02	6/30/02	9/30/02	12/31/02
Sales	100.0%	100.0%	100.0%	100.0%
Cost of Sales	63.4%	62.9%	63.0%	63.5%
Gross profit	36.6%	37.1%	37.0%	36.5%
Amort. of goodwill	1.2%	1.0%	1.1%	1.0%
SG&A	19.0%	17.4%	17.3%	17.4%
R&D	6.7%	5.6%	5.8%	5.6%
Operating income	9.7%	13.1%	12.8%	12.4%
Interest Expense	2.0%	1.7%	1.7%	1.7%
Other	0.0%	0.0%	0.0%	0.0%
IBIT	7.7%	11.4%	11.1%	10.7%
Tax	2.6%	3.8%	3.7%	3.5%
Net income	5.2%	7.6%	7.4%	7.2%

	FY 00	FY 01	FY 02	FY 03	FY 04	FY 05
Sales	13,994	13,542	13,583	13,393	13,106	12,795
Cost of Sales	8,316	8,395	8,584	8,840	8,912	8,956
Gross profit	5,678	5,147	4,999	4,554	4,194	3,838
Amort. of goodwill	154	153	148	150	150	150
SG&A	2,494	2,418	2,410	2,390	2,365	2,300
R&D	778	770	800	800	800	800
Operating income	2,252	1,806	1,641	1,214	879	588
Interest Expense	178	232	240	260	270	280
Other	111	16	0	0	0	0
IBIT	2,185	1,590	1,401	954	609	308
Tax	742	534	462	315	201	102
Net inc bef charges	1,442	1,056	939	639	408	207
EPS bef charges	\$4.70	\$3.63	\$3.21	\$2.17	\$1.38	\$0.70
Charges (after tax)	35	296	0	0	0	0
Net income	1,407	760	939	639	408	207
EPS	\$4.59	\$2.61	\$3.21	\$2.17	\$1.38	\$0.70
Shares	306.6	291.3	293.0	294.0	295.0	296.0

% of Revs	FY 00	FY 01	FY 02	FY 03	FY 04	FY 05
Sales	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of Sales	59.4%	62.0%	63.2%	66.0%	68.0%	70.0%
Gross profit	40.6%	38.0%	36.8%	34.0%	32.0%	30.0%
Amort. of goodwill	1.1%	1.1%	1.1%	1.1%	1.1%	1.2%
SG&A	17.8%	17.9%	17.7%	17.8%	18.0%	18.0%
R&D	5.6%	5.7%	5.9%	6.0%	6.1%	6.3%
Operating income	16.1%	13.3%	12.1%	9.1%	6.7%	4.6%
Interest Expense	1.3%	1.7%	1.8%	1.9%	2.1%	2.2%
Other	0.8%	0.1%	0.0%	0.0%	0.0%	0.0%
IBIT	15.6%	11.7%	10.3%	7.1%	4.6%	2.4%
Tax	5.3%	3.9%	3.4%	2.4%	1.5%	0.8%
Net inc bef charges	10.3%	7.8%	6.9%	4.8%	3.1%	1.6%
Charges (after tax)	0.3%	2.2%	0.0%	0.0%	0.0%	0.0%
Net income	10.1%	5.6%	6.9%	4.8%	3.1%	1.6%

CASH FLOW	FY 00	FY 01	FY 02	FY 03	FY 04	FY 05
<b>Operating Activities</b>						
Net income	1,442	1,056	939	639	408	207
D&A	889	900	800	800	800	800
Gain on sale of property	(117)	0	0	0	0	0
Changes in working capital						
Inventory	(282)	72	(5)	(17)	18	22
A/R	(247)	93	(8)	36	54	59
Liab and other	(444)	(200)	0	0	0	0
Cash payments from restructuring	(259)	(200)	0	0	0	0
Net cash from operating activities	982	1,721	1,727	1,458	1,280	1,087
<b>Investing activities</b>						
Capex	(945)	(800)	(800)	(800)	(800)	(800)
Sales of assets	277	30	0	0	0	0
Acquisitions	(130)	(244)	0	0	0	0
Marketable securities (net)	15	0	20	20	20	20
Net cash used in investing activities	(783)	(1,014)	(780)	(780)	(780)	(780)
<b>Financing activities</b>						
Change in debt	1,313	(200)	0	0	0	0
Dividends	(545)	(513)	(516)	(517)	(250)	(250)
Option exercises	43	40	30	30	30	30
Stock repurchase	(1,125)	(44)	0	0	0	0
Net cash used in financing activities	(314)	(717)	(486)	(487)	(220)	(220)
FX	(12)	0	0	0	0	0
Net change in cash	(127)	(9)	461	190	280	87
Cash at beg year	373	246	237	698	888	1,168
Cash at end of year	246	237	698	888	1,168	1,255