Palm faces 'make-or-break' event with launch of the Pre

May 27 2009, By Dan Gallagher

Few businesses rise or fall on a single product, but Palm Inc. has essentially banked its future as a company on a small, touch-screen wireless phone set to hit the market in just two weeks.

On June 6, the Palm Pre will go on sale in the United States, where the device will compete with better-known brands such as the iPhone and the BlackBerry in the fast growing market for so-called smart phones -- wireless devices capable of making calls, handling e-mails, managing calendars and surfing the Internet.

The launch comes a full six months after Palm first unveiled the device to great fanfare at the Consumer Electronics Show in Las Vegas.

Since that time, Palm's stock has tripled, as investors' expectations for the device have risen to levels typically reserved for one of the company's top rivals -- Apple Inc. This despite the fact that Palm has kept a tight lid on the product, allowing only a few select analysts to handle it -- always with a company representative nearby.

Palm declined a request from MarketWatch to see the device and answer questions for this article.

"It's fair to say that the Pre and the whole webOS platform are make-or-break products for the company right now," said Matthew Thornton, a wireless industry analyst for Avian Securities, who carries a neutral rating on the stock.

James Faucette, an analyst with Pacific Crest, said the Pre is important financially to Palm, which has been reporting net losses for the last several quarters and has been in negative cash flow for the last year.

"The Pre could get them back to viability. It establishes that that will be a player in the wireless market again," he said.

Palm is not the only one betting big on the Pre. Sprint Nextel Corp., which as the exclusive carrier for the Pre in the United States, also has a lot riding on a successful launch. Sprint has lost market share to rivals such as AT&T and Verizon -- in part because those companies have exclusive deals on popular smart phones such as the iPhone and BlackBerry Storm.

Among wireless device makers, Palm is in a unique position. Other device firms like Motorola and Sony Ericsson are also struggling, but

those companies have a wide family of devices selling across many different markets to many different sorts of customers. They also have other, non-handset business to fall back on in difficult times.

Not so for Palm. The company was an early pioneer in the smart phone space with its Treo family, which proved to be a popular draw for users looking to combine the planning functionality of the early Palm Pilot PDAs with cell phone and e-mail capabilities. Quarterly sales for the company peaked in late 2005 at $445 million, with pre-tax earnings reaching $36.7 million.

But the company was unable to survive the onslaught of competition. Much-larger, established device makers such as Nokia and Motorola were moving fast into the space, as were Korean conglomerates such as Samsung and LG. And the popularity of the BlackBerry from Research In Motion among corporate buyers took much of the business market away from Palm.

The final nail came in early 2007 with Apple's introduction of the iPhone. The touch-screen device and its associated App Store shook up the entire wireless industry -- and was squarely targeted at the well-heeled consumers who were Palm's last true customer base.

With few new products to compete, Palm's revenue base dried up. The company reported revenue of just $90.6 million in its most recent quarter, with a loss of $98 million. Palm's operations consumed $92 million in cash for the period.

Two years ago, Palm decided to go back to the drawing board.

The company secured a recapitalization deal with Elevation Partners, a private equity outfit partly owned by U2 singer Bono and Roger McNamee, a well known technology investor. Elevation took a 25

percent stake in Palm and brought on a former high-ranking Apple executive -- Jon Rubinstein -- so serve as executive chairman to oversee a restructuring of Palm.

Rubinstein also led the development of an entirely new operating system, one that could be used for an entire family of devices. When Palm debuted the Pre in Vegas, it was also the first time the public got a glimpse of the new platform -- which was dubbed webOS.

In a demonstration at the conference, the Pre operated much like the iPhone, along with the latter's famous "multi-touch" capabilities. But webOS also offers some unique differences, such as the ability to run multiple applications in the background, which enables users to more easily switch between apps.

"Even though most smart phone operating systems, such as Windows Mobile and the iPhone OS, can accommodate multitasking, the feature has not been turned on to date because running applications in the background is a huge drain on battery life," Charlie Wolf of Needham & Co. wrote in a report this week.

Wolf added that -- since Palm has kept a tight lid on the Pre and webOS -- it is not possible yet to objectively evaluate the claims.

Analysts say that Palm's ultimate survival will not depend on the Pre as a single device as much as it will depend on webOS becoming a platform for many devices.

"It's fair to say this device can't be a flop, but it's less about the device and more about the operating system," said Tavis McCourt, wireless analyst for Morgan Keegan. "The entire company is bet on the OS. There is no plan B."

The launch of the Pre with Sprint is the first step in Palm's planned comeback.

Next will be launching the device at other carriers in other countries. Palm has already signed Bell Mobility for a launch in Canada, sometime in the second half of the year. Analysts expect the company to line up carriers for other markets in the future.

"Sprint is a very comfortable launch for them. Overseas, Palm's brand is much weaker, so the company needs to execute there," said Thornton of Avian Securities.

While the deal with Sprint gives the carrier exclusive access to the Pre, Palm is widely expected to build other webOS devices for other U.S. carriers as well. But no such plans have yet been announced.

"Palm can't survive just being a handset provider to Sprint," McCourt said.

The Pre seems to have some big shoes to fill to be considered a success. The iPhone -- which was also launched on a single carrier in the summer -- sold 1.1 million units in its first full quarter of release and 3.7 million units in the 2007 calendar year. But some analysts say a comparison to Apple may not be necessary for Palm to be successful.

"Palm is a small company, with their initial distribution on a small carrier," said Faucette of Pacific Crest. "If they are able to do a few million units over the life-cycle of the device, that is sufficient for their strategy of building out their product portfolio."

A few analysts have made projections. Deepak Sitaraman of Credit Suisse predicts the Pre will sell 1.3 million units this year and 3 million in 2010. Vivek Arya of Bank of America thinks Sprint could activate 2.3

million Pre devices this year, which may not reflect all of Palm's sales for the period.

"We continue to believe that solid hardware specifications combined with an innovative new OS make the Pre one of the most compelling smart phones to launch this year," Sitaraman wrote in a report last month.

While the buzz has been strong -- and largely positive -- for the Pre, many on Wall Street are worried that Palm's current market value has already baked in a successful launch of the device.

Since lifting the wraps on the Pre in January, Palm's shares have skyrocketed. The stock crested the $12 mark last week _ triple its value before CES and the highest level for the stock since Palm closed the recapitalization deal with Elevation in the fall of 2007. It closed Tuesday at $11.17.

This valuation has made Wall Street nervous. Out of 24 analysts covering Palm, 12 are neutral on the stock and four rate the shares as a sell. Eight brokers maintain buy ratings, according to data from Thomson Reuters.

"It is our contention that even if the operating system performs as advertised, the resulting sales simply cannot justify Palm's current share price," Needham's Charlie Wolf wrote in a report Wednesday, in which he downgraded the stock to an underperform, or sell, rating.

Wolf added that he believes webOS "will be a worthy contender" in the smart phone market, but that Palm would need to sell more than 10 million units by 2011 to justify its current valuation.

Faucette of Pacific Crest maintains a buy rating on Palm. He believes

Palm could be a good acquisition target for a company like Nokia, Samsung or even PC maker Dell, which is reportedly planning its own moves into the smart phone space.

"Palm is in an interesting position. They don't have a lot of resources to work with, and not a lot of cushion," he said. "But if I look at the industry as a whole, Palm has the most valuable asset -- an operating system that could compete with the iPhone."

According to Faucette's analysis, Apple and Research In Motion are expected to take a combined 30 percent of the wireless industry's operating income this year, compared to 10 percent in 2007. That has hurt established players like Nokia, whom Faucette estimates has lost $5 billion in operating profits over the last two years to the two rivals.

"If you're Nokia, what are you going to do?" Faucette asked. "From that perspective, I'm not sure Palm is overvalued."

He added, however, that he does not expect a deal to materialize in the near-term, since Palm's owners would likely be uninterested in selling until the new operating system gains traction in the market.

Thornton of Avian thinks the main question facing Palm at the moment is whether it can get the Pre's production scaled enough to meet demand, and grow the user base from there.

"If they can execute, the turnaround will be successful for this company," he said. "They are not going to get a second shot."

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