APPLE COMPUTERS, INC.

Fine-Tuning Strategy - Re-Aligning Resources – Maximizing Shareholder Value

"Final Professional Challenge Paper"

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Part 1- The Ultimate Purpose of this Report
After considering many aspects of Apple's business in previous segments of this report, we now come to the central question:

How should Apple apply its financial and other resources today in order to <u>maximize shareholder value</u> in the future?

The bond refunding section of this report provided a glimpse of our final recommendations.

1. The brand image and foundation of Apple's strength comes from its ability to provide innovative, intuitive, useful products to a very loyal customer base.

2. The lifecycle of the computer hardware industry has reached a level of maturity in which its products are becoming price-driven commodities. This situation is diametrically opposed to Apple's strengths. Therefore, resources should be directed toward the development of new, industry leading products and applications rather than a narrow, hardware-focused approach that competes on price. Apple's hugely successful iPod and iTunes projects were cited as examples of this philosophy already in action.

3. The heart of Apple's Research and Development efforts should be focused on funding an "Imagineering" based "Skunk Works" type of experimental laboratory. All other departments should realign themselves to support these new product development efforts.

This final portion of our report will provide more in-depth justification for those actions and will specify how resources should be allocated.

Part 2- Forces at Work in Our Marketplace Today
While Apple began primarily as a computer hardware maker, software and other applications have become an increasingly important part of its product offerings. For that reason, we will consider the current state of both the hardware and software industries within the technology sector.

Hardware:
The price of personal computers has fallen dramatically over the past decade while their capabilities and performance continue to improve. Dell Computers has made the most of their working capital: developing an extremely efficient supply chain and using "Just-In-Time" delivery methods to become a leader in providing high quality computers at exceptionally low prices. (Brigham, E.F., & Ehrhardt, M.C., 2005, pg.742) Apple's focus has never been on a super-efficient supply chain or leading on price. It has been on enhancing the computer user's experience with innovative, high-quality, easy-to-use products.

"Apple's business strategy leverages its unique ability, through the design and development of its own operating system, hardware and many software applications and

technologies, to bring to its customers around the world meaningful new products and solutions with superior ease-of-use, seamless integration and innovative industrial design. The Company believes continual investment in research and development is critical to facilitate innovation of new and improved products and technologies."
(Apple Computer, Inc. 2004 10K SEC filing, 2005)

The outcomes of these two very different strategies can be illustrated by comparing two identically-priced Dell and Apple models. Both the Dell Dimension 3000 and the MacMini sell for $499. The MacMini is almost totally stripped-down. Only the Dell includes a monitor, keyboard and mouse.

APPLE "MAC-MINI"	DELL DIMENSION 3000
	

"It is ludicrous to expect that someone buying a Mac is going to want to plug in a pizza-stained three-year-old keyboard and a mouse chock full of desk scum."
(Jayson, S., 2005)

Apple would be ill-advised to focus on price competition because:
1. It would require major changes in supply chain and manufacturing processes.
2. Low price is not the foundation of Apple's customer loyalty. The company would likely lose existing customers in order to attract competitor's customers.
3. It is not in line with stated corporate goals.

Software:
For many years, Microsoft Corporation has been the 500 pound gorilla of software applications. One reason for this has been their history of sharing their operating system codes with third party software developers. Apple kept their code proprietary. In the early years of personal computing, this lead to a plethora of PC compatible software applications compared with those for Apple. That imbalance is no longer so prominent, yet the myth persists that buying an Apple means having limited software choices. (www.apple.com/myth)

To Apple's benefit, Microsoft's open code policy has also left their operating systems vulnerable to attacks by viruses and spy ware, problems that Apple users do not encounter.

Today, Microsoft's emphasis on code-sharing has turned to the use of *Extensible Markup Language* (XML), a sort of cross-platform "common tongue" that they believe will usher in the web services era. The web services concept is that software based on XML will be accessible to anyone, using any computer system and will be based on the internet rather than loaded onto individual machines. Rather than pay for software, users will pay for *access* to applications. Microsoft chairman, Bill Gates believes that the web services model will morph the software industry into a utility-like business, similar to gas, water and electric services. (VS launch webcast, Fawcett Publications, 2005.) These developments may seem like formidable competitive challenges, but things do not look so grim when we turn our attention to…

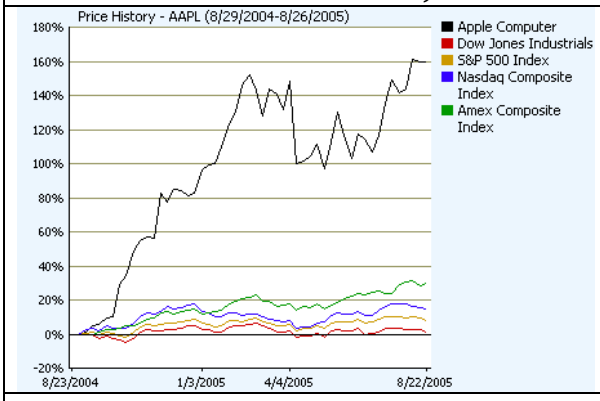
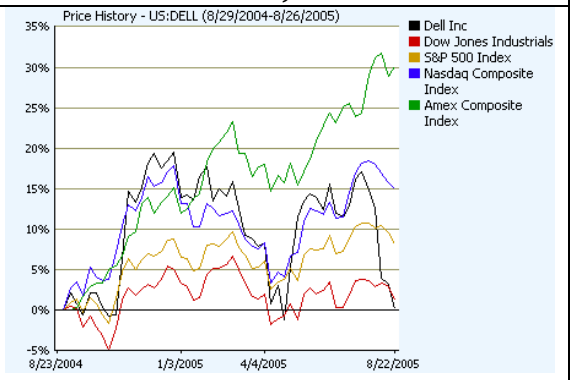
Part 3- Harnessing Apple's strengths to take advantage of opportunities.
"Play to your strengths" may be a cliché, but that is exactly what we are recommending. While competitors ask themselves, **"What can the computer do?"** touting their machine's megabytes of RAM and hard drive capacities or looking for answers in re-written software code, Apple should ask a different question:

"What can *PEOPLE* do?"

With a long history of intuitive, useful products, Apple has developed a loyal following and reputation for creating practical, user-friendly products. That is why we are recommending a renewed focus on Research and Development based on the needs and desires of computer users, revealed by through market research. Here is how that approach can help Apple to overcome the competitive challenges it faces:

Countering Threat #1: Low cost hardware.
We recommend a judo-like approach in which the firm just lets low-cost competitors continue to do what they are doing, responding instead with smart, inspired counter-attacks based on new products that people love, (and that also happen to maintain Apple's traditionally-high profit margins.) How confident are we that such an approach could work? It already has. Q3 2005 profits are the highest in the company's history, thanks in large part to Apple's music-based products and services. (www.apple.com/investors) Consider this: A $499 Dell with Windows Media Player will play tunes AND perform scores of other computing tasks, yet Apple sold millions of $200+ iPods that could not run a spreadsheet or a paint program to save their little lives. Conclusion: A product's ability to fulfill buyer's needs is often more important than the product's price.

Something else to consider is that sales do not automatically equal profits. This is especially true for a business like Dell, that competes on low margins. If profitability is reflected in the price of a company's stock, it seems that Apple's strategy is already proving itself successful compared to this low-cost competitor:

APPLE COMPUTERS, INC.	DELL, INC.
	

(Charts generated by MSN Money. http://moneycentral.msn.com/investor/charts)

Countering Threat #2: The dominance of Microsoft

Apple's approach to gaining market share vis-à-vis Microsoft should contain both a general strategy and a specific tactic. We recommend an overall strategy based on this question: *"Who cares what they do?"* If Apple pursues a customer-focused approach to developing new products that prove to be popular and profitable, the actions of any competitor will only be relevant to the extent that they attempt to copy Apple products.

> *"The iPod is revolutionizing the music download, listening and broadcasting habits of millions of Americans. Everyone from Disney to Newsweek to NPR is now offering podcasts and Apple Computer recently made it a whole lot easier to find and download them."* (Associated Press, 2005)

While Microsoft focuses on re-writing software code, Apple is already finding success in a wide range of products and services that go far beyond traditional computing. Here is a small sample:

PRODUCT	DESCRIPTION
iPod	Extremely successful. Not a computer.
iTunes	World's leading online music download store. Also not a computer.
Motorola's ROKR phone from Cingular can download and play music from iTunes.	Alliance with Cingular allows wireless access to Apple music products. Wireless is now a distribution channel for music sales.
Final Cut Pro film /video editing software	Apple takes the lead in yet another line of business—media post-production. "Apple's Final Cut Pro has been the industry standard for professional filmmakers for years." (Plumer, C. 2005)

That being said, we will now totally contradict ourselves by recommending one specific tactic. Apple is *and has been* missing an opportunity to exploit Microsoft's weaknesses. Beginning immediately, Apple's should aggressively promote the superiority of their

desktop and laptop computers over those running Microsoft operating systems, especially in the professional market. They are faster, more stable, extremely powerful and functional. The "lack of software" myth is exactly that. Switching to Macs will eliminate costly losses caused by viruses and other malicious software.

Part 4- Fine-tuning Apple's structure and resources to meet these challenges.
To summarize, we are recommending a strategy that contains three elements:

-(market research)-
What is the most effective strategy for creating innovative products that people are eager to use? The Microsoft approach would be to turn inward to find ways to improve their software codes. For Dell, it might mean finding a lower-cost way of adding more memory and hard-drive capacity to their machines. Apple should take a more enlightened approach. The best way for us to create innovative products that people love to use, is to ASK THEM… ask them what they like and don't like about existing products… ask them to dream and describe their ideas of "perfect" products.

-(product research & development)-
Given a clear idea of what people really want, Apple can then combine its engineering and operations skills in a "Skunk Works" Research & Development environment. This is not a re-invention of Apple's wheel. It is merely placing a clear, company-wide emphasis on using input from customers to guide the development of new, profitable products in a free-wheeling, creative environment in which ***there is no box for anyone to think outside of.***

-(follow through with efficient Marketing, Manufacturing and Distribution)-
When new product lines are ready, Marketing can then test and mass-market them while Operations manufactures and distributes them. More details on these aspects appear below.

Part 5- The Financial Strategy that is the foundation of this plan.
Before making a commitment to such a plan, several questions must be addressed:

1. R&D can be an expensive gamble, especially if done in the free-wheeling manner described. Is the investment worth it? Is now the best time?
Yes and yes. Again, we can point to the success of the iPod as evidence that product innovation is key to Apple's future profitability. Speaking of which, recent profits have been among Apple's highest ever. If there was ever a time that the firm could afford to invest in R&D, it is now.

2. Which other functional areas will also require increased capital expenditures?
The strategy begins with extensive **market research**. Compared to the costs of manufacturing or advertising, this effort will require a relatively small budget, yet it will surely require more funding that it currently gets. **Advertising and other Marketing** initiatives will be required to promote the new products created by R&D. If successful, operating costs could rise sharply as raw materials, labor, energy and shipping costs grow

to meet demand, so **Operations** would require additional initial funding. Cash flows generated by those sales should provide satisfactory returns on these investments.

3. Should Apple's Capital Structure be changed to meet these new challenges? Should new expenditures be funded with debt, equity or a combination of both?
This equation will change as new products begin to hit the market. To begin with, we recommend a combination of reinvested equity from recent record profits and the comparatively low-cost debt made available through the $80M bond refund, as explained in the previous installment of this report.

As new product lines gain acceptance and popularity, they will produce new cash flows that should allow the firm to return to its traditional capital structure that contains very little if any debt. Funding to continue and expand new product development should be able to come from reinvested equity. This will work *if and only if* stockholders are convinced that the Net Present Value of new product cash flows will be greater than the amount invested in developing them. After all, the ultimate goal of this strategy is to maximize stockholder value.

4. Where and how can we cut costs without cutting corners on important functions?
Despite the extensive need for capital this strategy demands, there are ways that each aspect of it can be made more efficient.

Finance- The single most powerful weapon at our disposal, in terms of making this initiative as efficient and profitable as possible is careful, ***skillful financial management*** that leverages the maximum value out of every asset, operation and individual.

Market Research- Apple's omnipresence on the internet can provide many opportunities for low-cost market research, using ***web-based surveys***. ***Data mining*** will also be used to lift customer feedback and ideas from the customer service and technical support departments.

Research & Development- Although this area will be heavily funded and unregimented, ***bonuses and other rewards should be tied directly to cash flows*** generated by the products that each individual was responsible for developing. This emphasis on accountability should reduce agency risk and prevent researchers from pursuing unprofitable pet projects.

Operations- While we do not recommend pursuing the low-cost strategy employed by Dell, Apple can nonetheless borrow some tactics from their playbook. Product orders probably already come via the internet, whether from customers on the website or retail store managers placing bulk restock orders. If turnaround times allow, Apple should adopt a ***"Just-In-Time" supply chain strategy*** that shifts more of the inventory costs to suppliers. ***Internet orders*** could automatically generate orders to vendors for raw materials that will be needed for those orders.

Since a variety of products may require a variety of raw materials to produce, one idea to consider is to ***de-centralize manufacturing operations*** to whatever part of the world production can be accomplished at the lowest cost.

Distribution can be economized by using ***web-based purchasing*** that would allow products to be shipped directly from the factory to the customer, rather than from the factory to a warehouse to the customer.

All of these strategies for streamlining operations will have to be ***studied before they are implemented***. Consider these to be ideas to be investigated rather than direct recommendations, especially those related to Operations.

Part 6- The Bottom Line

Imagine living on a planet that spins so quickly that the sun rises every four hours instead of every twenty-four. While other businesses may live an Earth-like existence, the technology sector has always spun rapidly on its axis, with new products constantly rising, setting and changing. This is not an environment in which a firm should find itself in a position of trying to keep up. It is far better to t lead and let competitors worry about keeping up. That is why we are recommending increased capital investments focused on Research and Development, supported by spending on market research, production and promotion of new products. ***Creating exciting new products that are based on a clear vision of what people want*** should be the basis of Apple's future success, profitability and value to shareholders. That's the bottom line.

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