

## UBS Investment Research

# The Sentiment Snapshot

### Eye on IT : IT Panel Takeaways

#### ■ Spending trends in 2008 and 2009

We hosted senior UBS technologists to discuss the state of IT software and hardware spending in 2008, expectations for 2009, as well as an overview of security, virtualization and data center strategies. Overall, IT spend is likely to be down 5-15% y/y in 2008 vs 2007. Although 2009 is difficult to assess at this point in time, spending could decline by a similar amount.

#### ■ Security Trends: Increased Spending and Large Vendors

Security spend is expected to increase 10% y/y in 2008 and 15% in 2009 as companies need to continue spending on security and compliance requirements even in a down economy. We note that while MFE and SYMC were able to sign large deals in 1H08, we believe that the deteriorating macro environment could make it difficult for both companies to maintain the same pace in 2H08.

#### ■ Virtualization Trends

As the economic environment constrains IT budgets, server virtualization spend is not immune and current spend with VMware could decrease. As well, the panelists commented on alternatives to VMware's offerings and noted that initial tests of Microsoft's Hyper V were positive.

#### ■ 2009 Hardware Spend To Be Weak; But Some Areas Worse Than Others

The panelists indicated that there were certain areas of hardware that would be weaker than others on a relative basis. Ranking hardware from the highest spending priority level to the least, UBS sees storage remaining as the highest priority, followed by servers and then desktops.

13 October 2008

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## IT Panel Takeaways

We hosted an IT Panel with senior UBS technologists in our New York Office on Friday. Our panelists included: Scott Abbey, CTO; Gordon Elliott, Global Head of Finance IT; Anthony Belfiore, Global Head of ITI Security Operations; Keith Knuckey, ITI, Head of Global Data Center Strategy & Planning; Michael Breuer, ITI, Head of Architecture; Mike Donnelly, ITI, Distributed Systems & Storage; Jan Glikman, ITI, Technical Product Manager, Remote Computing & Remote Access.

The key takeaways from the panel discussion follow below.

### Overview of IT Spending in 2008 and 2009

Overall, IT spend is likely to be materially lower in 2008 versus 2007. Excluding contractual commitments for 2008 that were made in prior years, estimates are that 2008 spending could be down 5-15% y/y. Two key trends driving spend lower include: 1) revenue pressures, write-offs and cash conservation that are causing financial institutions to look at technology spending for savings as it typically accounts for the largest non-personnel expense on the P&L, and 2) people are thinking about buying less yet still being able to do more. Looking out to the December quarter, while the year end is typically the busiest period to close deals with vendors, expectations are that there are not likely to be purchases of any meaningful size in 4Q this year suggesting that the typical Q4 budget flush is unlikely to occur. As well, although 2009 is difficult to assess at this point in time, spend could decline by a similar amount.

We note that our enterprise software field checks both in the U.S. and Europe were extremely mixed as we exited the September quarter. For some, the market volatility of the past 2 weeks in particular had an impact on deal signings in the all important last 2 weeks of the quarter. For others, our field checks indicate deal signings continued as planned, albeit with a higher level of scrutiny than we have seen in recent years. The one constant in all of our channel conversations has been that there is practically no visibility right now and as such they themselves are setting very conservative targets for Q4. As a result, we feel confident that 4Q guidance for enterprise software companies will certainly be impacted by the recent macro dislocation and we expect to see signs of this to also begin showing up on the deferred revenue line of the balance sheet. In our view, it will be interesting to see if companies that normally give out-year guidance or even 1 quarter out guidance will continue to maintain that policy.

Our panelists indicated, however, that maintenance spend is very sticky and noted that during the tech bubble in 2001 financial institutions were not able to renegotiate maintenance rates much lower with large vendors such as Oracle, Microsoft and SAP (reduced maybe 2 to 3 percentage points). Given that most financial institutions likely have multi-year maintenance agreements, any changes in support contracts are likely to be deferred over the next couple of years. From a software perspective, we note that our channel checks indicate that while larger vendors are not immune from the macro environment, they are relatively well positioned to weather the uncertainty as companies reallocate

spend from tightened or already reduced budgets and give an increasing percentage of their overall budgets to these large vendors.

## Security Trends: Increased Spending and Large Vendors

Spending in security software seems to be one of the few bright spots that have not been impacted by the deteriorating macro environment. Our security expert, Anthony Belfiore, Global Head of ITI Security Operations, expects security spending at UBS to increase 10% y/y in 2008 and forecasts an additional 15% y/y increase in 2009. He argued that the firm is most at risk in economic downturns as his organization has to protect against issues as disparate as laid-off employees taking confidential information to increased efforts by hackers to bring down the firm. He also noted however that while financial services and government entities will need to continue spending on security and compliance requirements even in a down economy, other industry groups that are as regulated would likely pull back. Mr. Belfiore notes that he wants to simplify his vendor dealings so the winners of this increased spending are the large security vendors with a full portfolio of security products such as McAfee, Symantec and RSA. This is in agreement with our channel checks who mentioned that they prefer to deal with vendors who can offer integrated solutions. Mr. Belfiore notes that as these firms diversify and fill out their product suite, he can replace the proprietary in-house applications (which have high people costs) with new software licenses. He also mentioned that since the firm operates in a heterogeneous software environment due to legacy systems and software being kept after mergers, there is a risk that installation of new software could have an adverse impact on system performance. With a multi-product service provider, the update could be installed as a patch to 100k users and the chance of issues arising are much lower. Therefore the incumbent security vendor, McAfee, seems to have a large advantage but Mr. Belfiore mentions that the firm will be looking to overhaul its desktop operating system platform and choose its main security vendor at the same time giving Symantec a fair opportunity as McAfee's incumbent status is mitigated. Given his preference for working with a "one stop shop", Mr. Belfiore was predictably pleased when asked about his thoughts on McAfee acquiring Secure Computing although he also commented that our current vendor's products are viewed as superior at this point in time. He reiterated his thoughts on the full product suite model and mentioned how an ArcSight and McAfee combination could benefit each other. He also positively mentioned how Novell had been buying many security companies and was being competitive with pricing.

While McAfee and Symantec were able to sign large deals in 1H08, we believe that the deteriorating macro environment could make it difficult for both companies to maintain the same pace in 2H08. To be fair, these two companies derive a significant percentage of current quarter revenue from deferreds on the balance sheet (i.e., 80% for McAfee and 65% for Symantec). As such we think this makes them less of a candidate for a preannouncement as any impact would be reflected in the balance sheet in the near term. Due to the strengthening dollar vs. foreign currency, both companies face a big hit to deferred balances (-5% since Euro 1.34 on 10/10 vs. 1.41 on 9/30).

## Virtualization Trends

As the economic environment constrains IT budgets, server virtualization spend is not immune. Keith Knuckey, UBS Head of Global Data Center Strategy & Planning, said current spend with VMware could decrease. This remark is consistent with management's statement on its June quarter conference call that pricing was coming down and approval cycles for deal signings were lengthening. Further, Knuckey noted that the firm is looking for alternatives to VMware's offerings. Additionally we note that initial lab tests of Microsoft's Hyper V hypervisor were positive. While Hyper V lacks some of the additional functionality of VMware's offerings such as VMotion, UBS technologists stated the advanced features are not a necessity. We believe this is a fact customers will use in negotiations with VMware. With the current economic environment and the launch of Hyper V, we expect the trends toward reduced pricing and protracted approval times to continue.

While UBS currently uses VMware for desktop virtualization needs, Citrix offers significant advantages in the desktop virtualization space primarily due to its ICA protocol. Jan Glikman, Technical Product Manager-Remote Computing & Remote Access, noted that the ICA protocol is superior to both the remote desktop protocol (RDP) offered by Microsoft and Sun's AOP protocol. Further, Glickman state that Microsoft's RDP is not well suited for enterprise use because of the physical distance involved, but that it may be appropriate for the SMB market. Additionally, VMware is still in the process of developing a proprietary protocol that improves on RDP. As such, we would expect Citrix to play a larger role in future deployments of desktop virtualization.

## 2009 Hardware Spend To Be Weak; But Some Areas Worse Than Others

Although IT spending levels in 2009 are expected to be down materially from the fairly soft spending in 2008, UBS IT indicated that there were certain areas of hardware that would be weaker than others on a relative basis. Ranking hardware from the highest spending priority level to the least, UBS sees storage remaining as the highest priority, followed by servers and then desktops.

**Still need to spend on storage.** Although storage spend is expected to be down in 2009 (the expected decline was not quantified), the drop off is not expected to be as dramatic compared to other areas of hardware. In addition to constrained IT budgets and the need to reduce costs in all areas, UBS stated that the expected decline in storage spend is also a function of improved utilization going forward which should help drive the need for less capacity. With technologies such as virtualization and data de-duplication helping to improve the efficiency and disk utilization of storage systems, companies are able to store and manage increasing amounts of data with less storage. However, the improved efficiency that is expected is not enough to offset the rapid rate of data creation and various regulatory requirements which are still driving storage spending and resulting in storage remaining high on the IT spending priority list. With storage only comprising 4% of sales for both HP and Dell, we believe these storage spending trends should have a minimal impact on the overall businesses for these companies relative to servers and PCs.

**Excess capacity, low utilization rates and virtualization impacting server spend.** As expected, server spend will also be down in 2009 after a challenging spending environment in 2008. In addition to a decline in spending, UBS plans to have fewer servers on the ground at the end of 2009 versus the number in 2008 (number of servers at the end on 2008 are expected to be lower than 2007). The significant amount of excess server capacity is a key driver of the server spending trends UBS is anticipating, with UBS IT stating that back office server utilization rates are about 50%, with front office utilization running at only about 25%. With a significant amount of excess capacity and the efficiency improvements driven by the growth of server virtualization, UBS sees servers as an area where spending can be limited over the next year or so, with minimal performance disruptions.

Although it is clear server unit sales should experience some weakness, UBS indicated that it will be spending on higher ASP systems that have greater computing power and have the features and functionality that better utilize virtualization solutions. Although we believe a shift to higher ASP systems should offset some of the industry impact to server revenue growth, we believe it will likely not be enough given expectations for fairly soft unit demand. In terms of potential impact to HP and Dell, we believe slowing server spend could be a factor placing pressure on top line growth over the next few quarters. Note that servers account for about 14% of HP sales and 11% of Dell's.

**Desktop spend at bottom of priority list.** In terms of desktop spending, UBS sees this as one of the lowest spending priority areas in the bank. In the current environment, desktop spend is not even being considered given that desktop refreshes can be easily delayed without impacting performance. We believe desktop spend will remain rather subdued until a need for an OS upgrade is needed or the refresh cycle can no longer be delayed. We believe challenging PC growth through 2009 will be the main factor weighing on the performance on HP and Dell given their significant exposure to this market. PCs account for approximately 34% of HP sales (desktops 15%) and 61% of Dell's (desktops 32%). With Dell's financial performance being more exposed to PCs as well as the corporate market, we believe the impact from a drop off in enterprise desktop spending could be greater for Dell compared to HP.

**Keep an eye out for increased vendor financing.** Another area that was briefly touched upon was vendor financing. With many customers being cash constrained at this time, UBS noted that they are seeing IT hardware vendors finance more transactions. Although still a relatively small piece of their overall businesses, we believe increased financing activity could help offset challenges in other segments for HP and Dell. However, given increasing concerns in the market around extending credit, we believe increased customer default risk is an issue that should also be acknowledged.

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### ■ **Statement of Risk**

As with other technology sectors, the enterprise software universe is highly volatile, and we expect the share prices to continue to reflect this volatility. Although IT spending appears to have stabilized, we believe the environment for closing large deals remains constrained. Additionally, recent merger and acquisition activity in the enterprise software sector could cause technology buyers to postpone purchase decisions. Furthermore, the expensing of stock options will negatively impact the EPS figures for the majority of companies in our coverage universe.

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| UBS 12-Month Rating   | Rating Category | Coverage <sup>1</sup> | IB Services <sup>2</sup> |
|-----------------------|-----------------|-----------------------|--------------------------|
| Buy                   | Buy             | 56%                   | 36%                      |
| Neutral               | Hold/Neutral    | 35%                   | 33%                      |
| Sell                  | Sell            | 8%                    | 27%                      |
| UBS Short-Term Rating | Rating Category | Coverage <sup>3</sup> | IB Services <sup>4</sup> |
| Buy                   | Buy             | less than 1%          | 32%                      |
| Sell                  | Sell            | less than 1%          | 14%                      |

1:Percentage of companies under coverage globally within the 12-month rating category.

2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.

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Source: UBS. Rating allocations are as of 30 September 2008.

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|-----------------------|---------------------------------------------------------------------------------------------------------------------------------------|
| Buy                   | FSR is > 6% above the MRA.                                                                                                            |
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