

ANNEX BULLETIN

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February 7, 2006

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Updated 2/09/06, 12:30PM MST, adds [EDS Rocks](#)

Analysis of CSC's Third Quarter FY06 Business Results

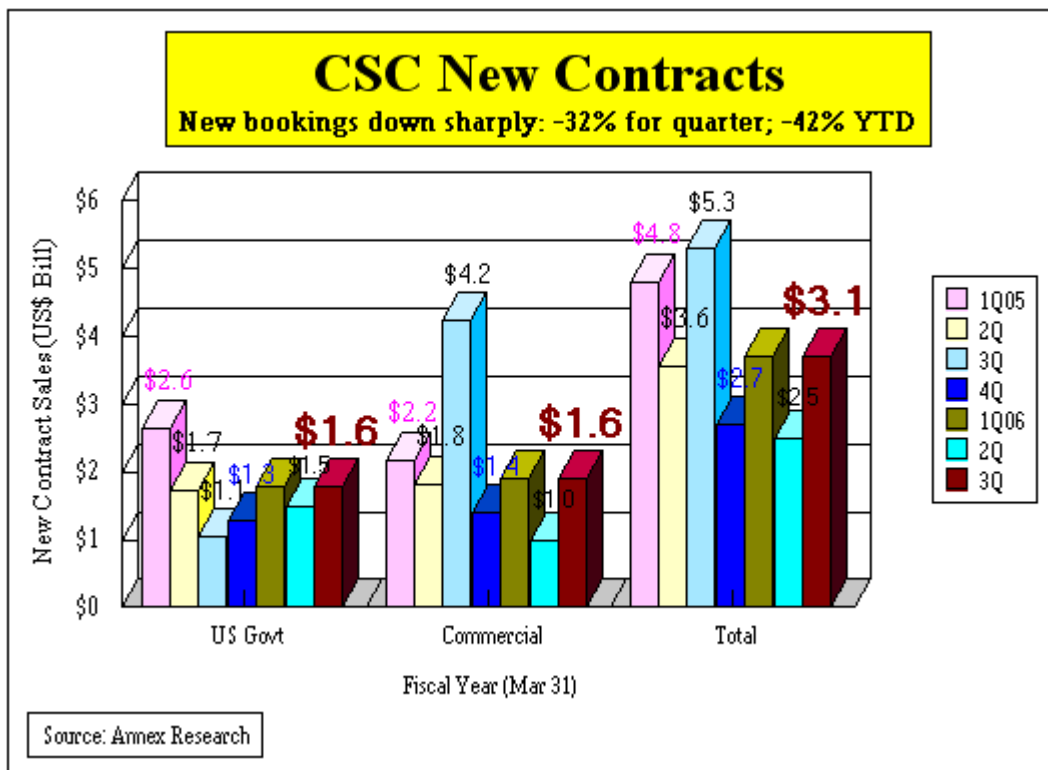
Mixed Messages

Earnings Please Investors; Revenues Disappoint, As New Contract Sales Plummet

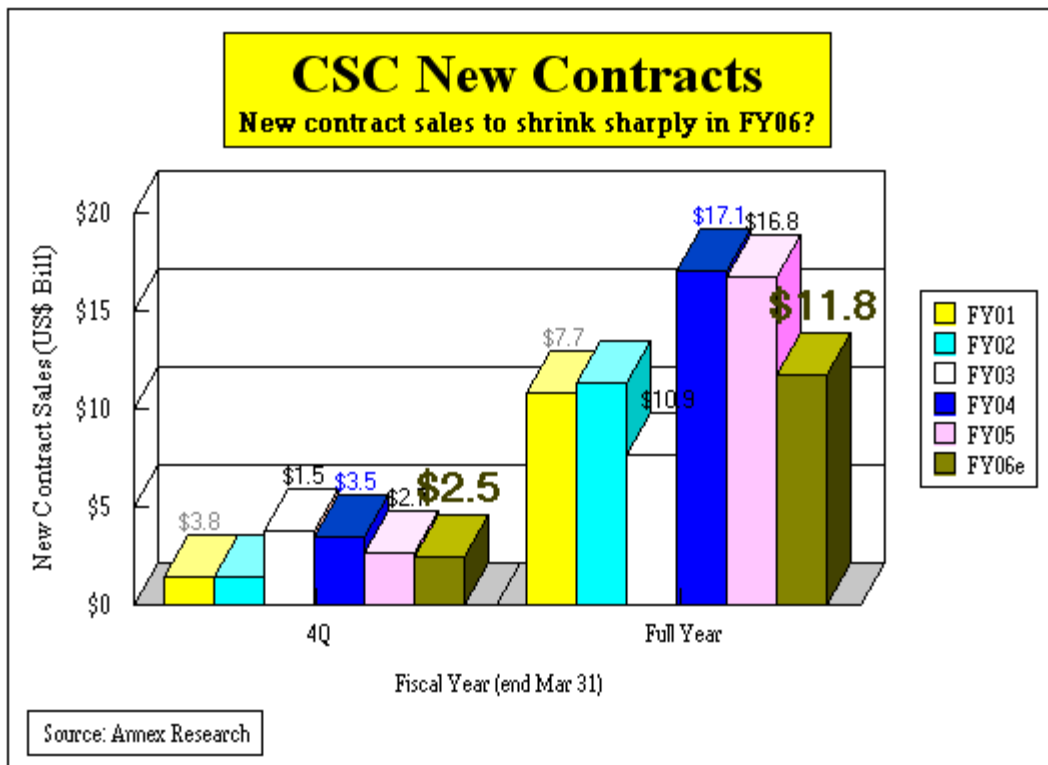
EDS Rocks: Fourth Quarter Results Exceed Expectations

SCOTTSDALE, Feb 7 - Computer Sciences Corp. (CSC) became the latest IT company to vex investors. Its shares dropped 1.6% prior to the release of its third quarter fiscal year 2006 business results, after the markets closed today. They recovered about a point in after-hours trading, as the company's results sent mixed messages to the market place. Earnings came in slightly better than expected, but revenues, up only 2.5%, disappointed Wall Street.

To us, however, the most disappointing aspect of CSC's latest financial release was the implied cause of its slowing revenue growth - sharp declines in new contract bookings. For the quarter, they were down 42% relative to the same period a year ago. Year-to-date, they were down 32%.



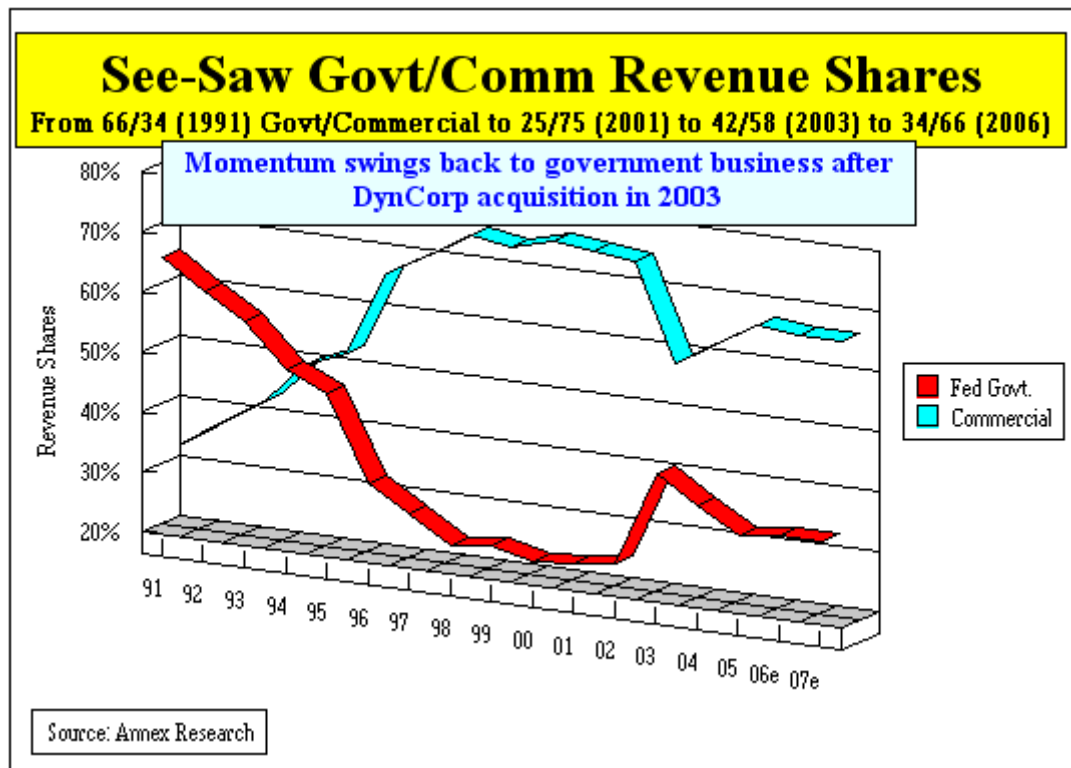
Which means that our earlier forecast - that CSC's new business sales in FY06 would be down relative to FY05 - is a virtual certainty now.



Especially worrisome is the fact that the sharpest decline new business sales has occurred in the commercial market. It is down 47% year-to-date

from the corresponding nine-month period in FY05. Maybe that's why CSC's CEO, Van Honeycutt, chose to stress the federal government business.

"The market for U.S. federal government information technology (IT) services continues to demonstrate solid demand," Honeycutt said in a release. He blamed the weakness in commercial sales on "soft demand in certain country-specific markets."



But there was plenty of "softness" in CSC's sales numbers, the company's expansion into India is going great guns. The number of CSC employees based in India jumped 77% at the end of December compared to the same point a year earlier, according to Leon Level, the CFO.

"We will continue to invest in and grow this important part of our business as appropriate to most effectively meet the needs of our customers and most efficiently improve returns to our investors," he said. "We continue to expect significant growth offshore, primarily in India, as we continue into the new fiscal year."

Well, at least in India, CSC has plenty of company (see "[An IT Potpourri \(IBM, Fujitsu, Accenture\)](#)", Jan 2006). Which is not exactly a compliment. The more demand for Indian labor, the higher the wages, and, therefore, the lesser allure of the Indian market (check out "[A Passage to India,](#)" July 2003, for our forecast regarding that trend).

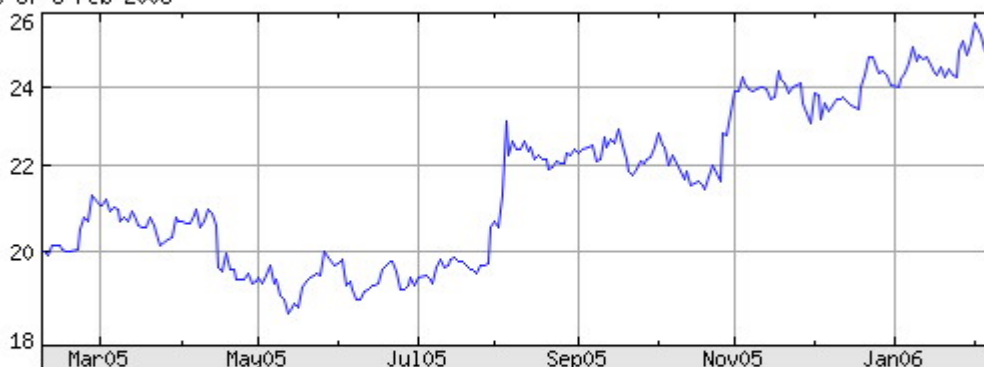
EDS Rocks: Fourth Quarter Results Exceed Expectations

SCOTTSDALE, Feb 9 - Electronic Data Systems (EDS) is rocking once again. The company returned to profitability in 2005 largely on the strength of the fourth quarter in which it made money for the first time on its beleaguered NMCI megadeal.

"We're back to profitability, and that profitability will grow significantly" in the next couple of years, CEO Mike Jordan said in an interview with the Wall Street Journal. He also declared the EDS turnaround to be "largely complete."

Not so fast. One quarter does not make a turnaround. Not anymore than one swallow makes a spring, especially in February. Jordan's optimism could be interpreted a "declare victory and run like hell" proclamation. Is the EDS CEO getting ready to head for the hills himself? The next several quarters will show if this was a lonely swallow or a sustained recovery.

ELECTRONIC DATA SYSTEMS CORP
as of 8-Feb-2006



EDS stock surges by six points in after-hours trading, up 1.7% in the AM

Meanwhile, the stock market seems to have bought Jordan's "completed recovery" story lock, stock and barrel. EDS shares surged by over six points in after-hours trading on February 8, and then eased this morning while still keeping a 1.7% gain. More importantly, the EDS stock has been a steady climber ever since about early May (see the chart).

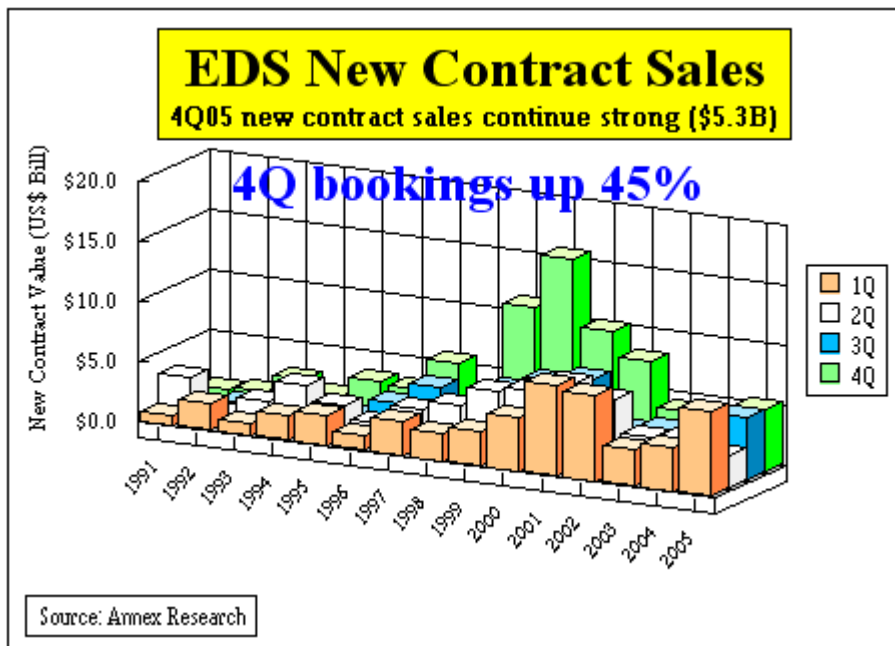
So much for perceptions. And now about the facts. EDS revenues for the year were down 0.5% to \$19.8 billion. EDS earnings for the year were down 5% to \$150 million. So what's all the shouting about?

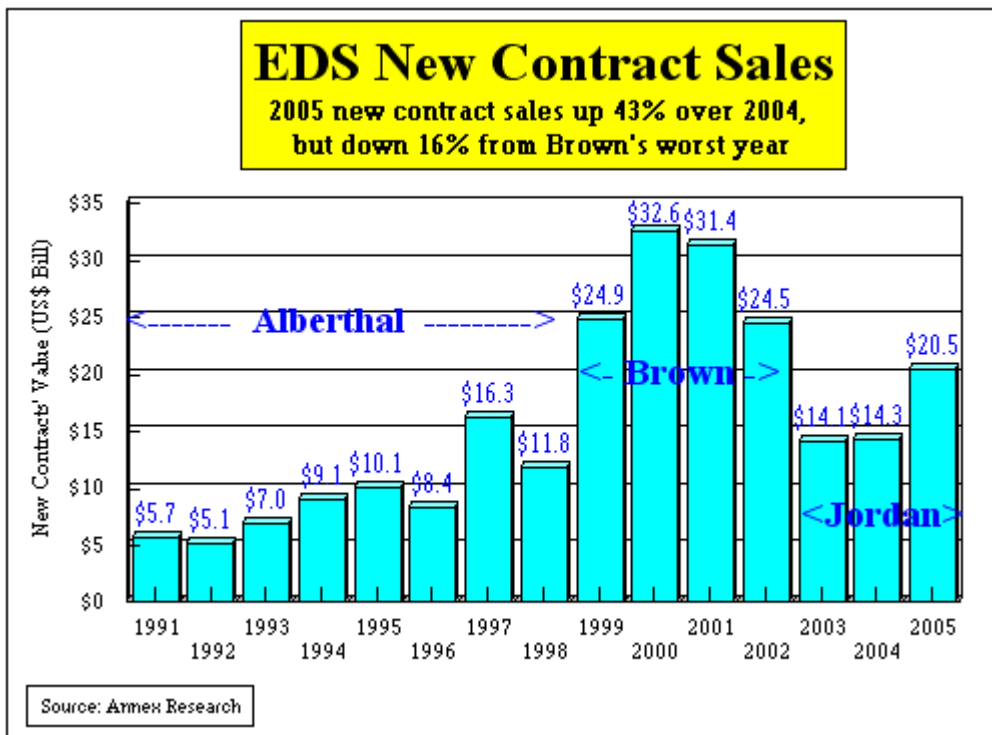
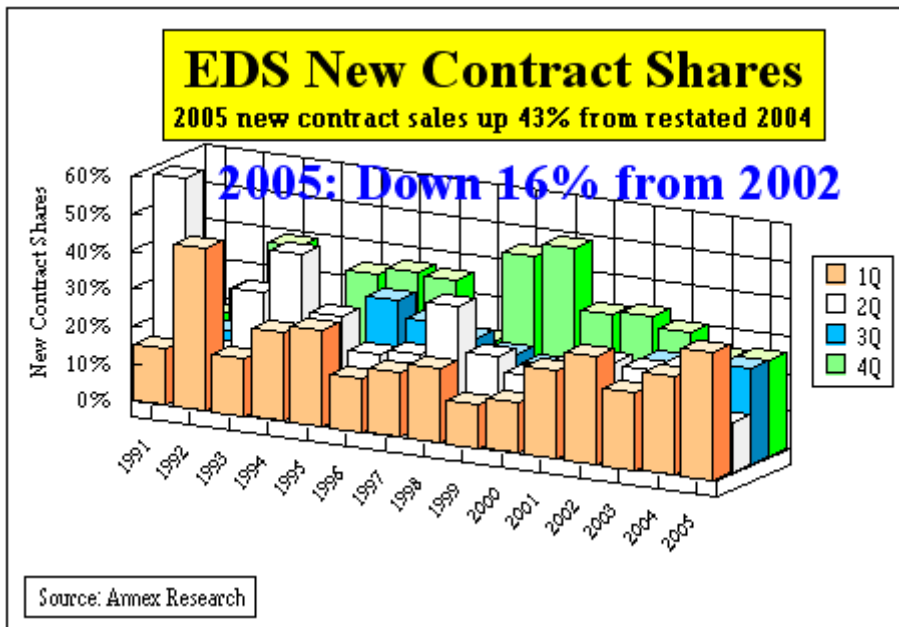
Well, when you quit hitting your head against the wall, it sure feels great. And that's how EDS owners must feel about the status of the company's turnaround right about now. Many of EDS' pain points are healing or have gone away. The NMCI is no longer bleeding red ink to the bottom line, nor is AT Kearney, which was sold last year. And EDS will get to keep a [fair chunk of its GM business](#) that many had feared would go to competitors.

As a result, free cash flow surged to \$619 million in 2005 from \$304 million the year before. And EDS' net profit actually more than doubled in the fourth quarter to \$112 million, from \$53 million in 2004. So some blue skies are starting to open up after many dark clouds in the last three years.

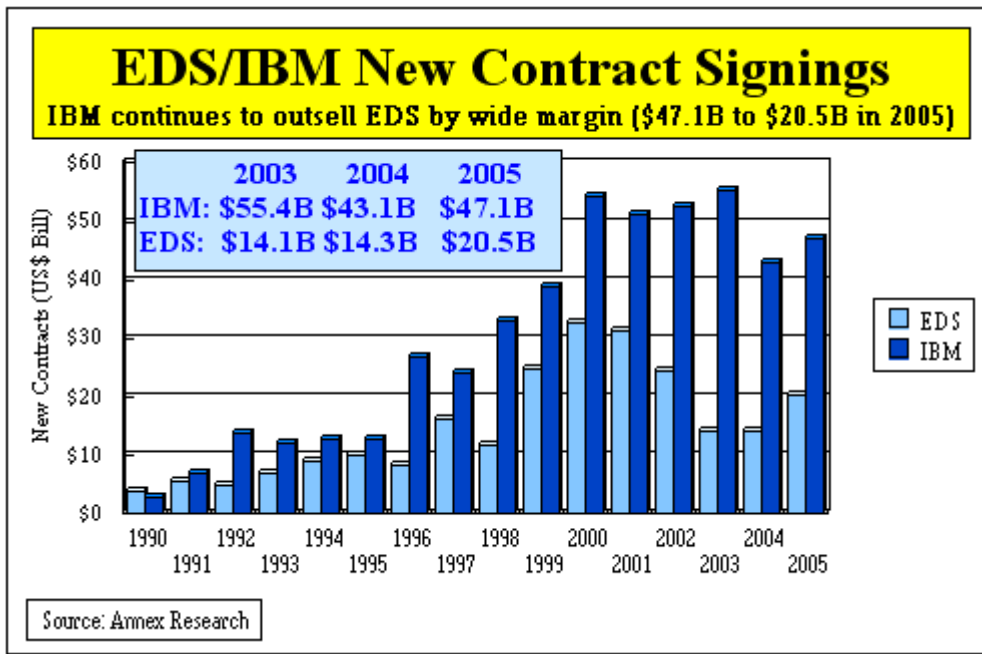
Strong New Contract Sales

Perhaps the most encouraging positive EDS sign is its new contract sales. For a second quarter in a row, they were \$5.3 billion. That lifted the total for the year to \$20.5 billion, up 43% over the \$14.3 billion the company closed in 2004, and the fourth quarter new contracts by 45% over the corresponding period a year ago.

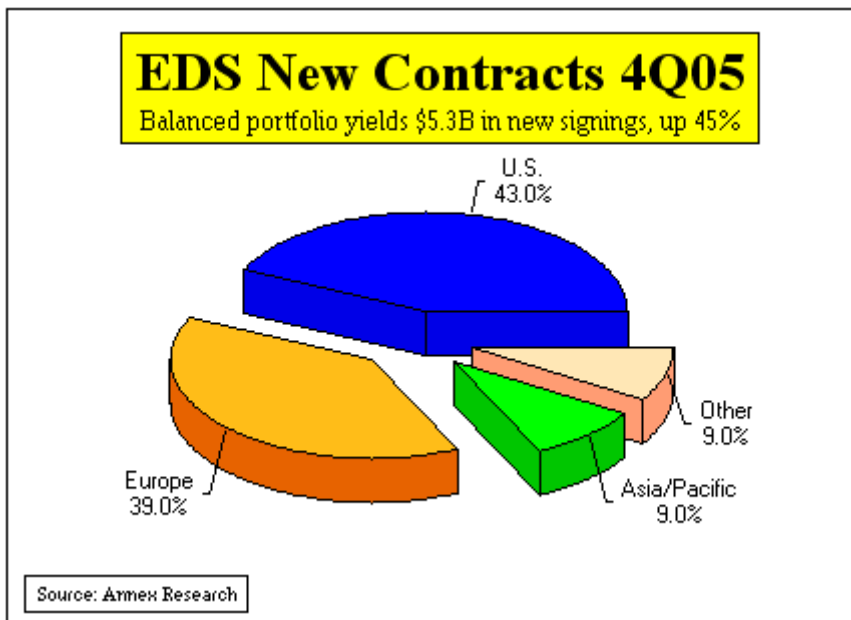




But the 2005 rebound in new contract signings still left Jordan's best year about 16% short of Brown's worst year (2002 - see the charts).



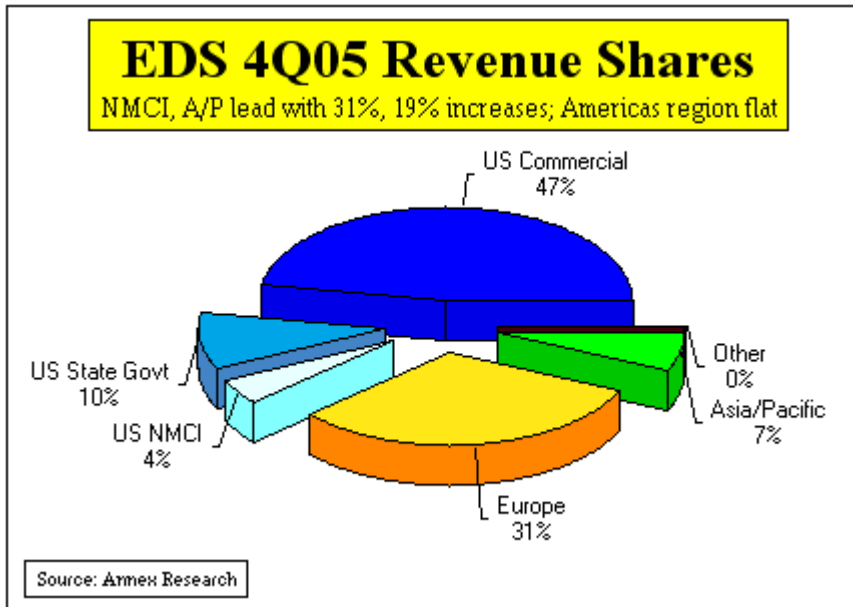
On the plus side, EDS's 43% jump in 2005 new bookings suggests that the company has gained new business market share on IBM, its chief rival and the only bigger competitor. Big Blue has been outselling EDS by a wide margin ever since 2001 (see the chart).



What we also liked about EDS' new contract performance in the fourth quarter is that it did not contain any huge deals, and that it was fairly well balanced between its geographic regions (see the chart). This suggests that the company's work in the trenches is paying off.

Business Segment Analysis

Among EDS's geographic regions, Asia/Pacific, the smallest area, reported the best growth in the fourth quarter. Revenues were up 19% to \$346 million.



Europe was up 3%, while Americas, EDS's biggest region that accounts for nearly half of its business, was flat. The government business, excluding NMCI, also increased by 3%.

As for the NMCI contract, its revenues surged by 31% to \$224 million. And the deal posted an operating profit of \$2 million versus a \$65 million loss in the fourth quarter of 2004.

Outlook

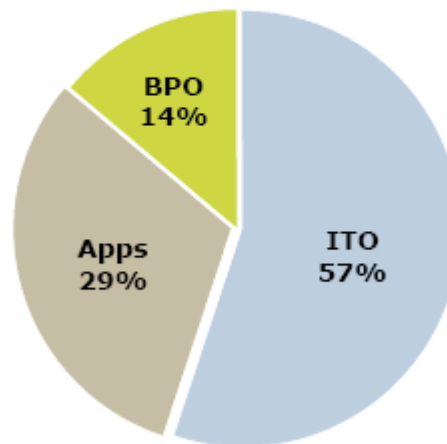
We see EDS revenues growing slightly (up 1%) back to about a \$20 billion level in 2006. With all the actions that EDS management has taken so far, we expect a bottom line net profit of about \$428 million, or a 2% net margin ([click here to view the detailed table](#)).

That's not much to write home about, of course, but it is a vast improvement over the losses in 2003 and 2004, and a 50% jump from 2005.

When you start out with a gross margin of only 12%, i.e., before you feed and take care for your employees, there is not much money left to flow to

Segment View

4Q 2005 Revenue

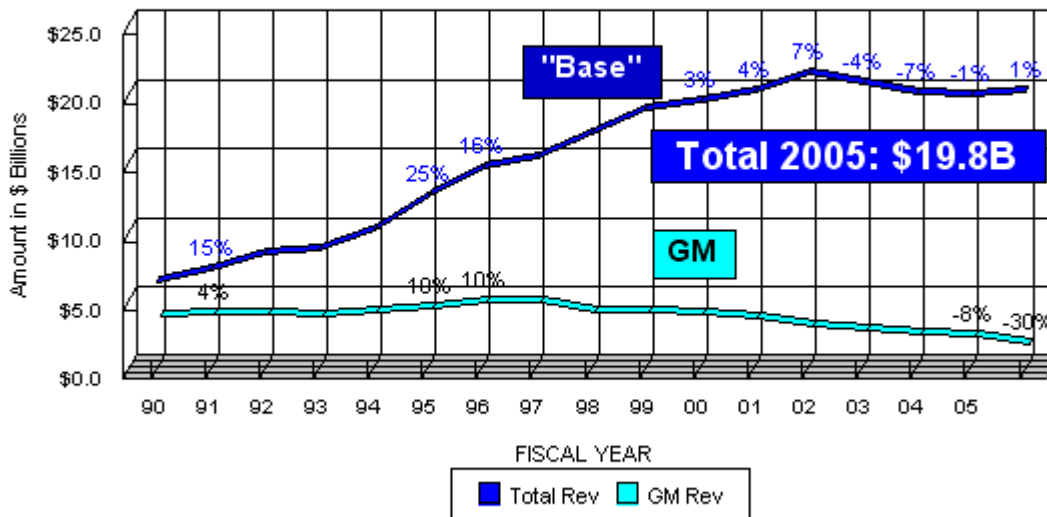


the bottom line. What EDS needs to do in order to improve its gross margins is to stop chasing the megadeals, and try to grow its business in SMB markets. Of course, that's the same advice we gave the company six years ago, but it evidently fell on deaf years (see "[EDS e-Price Clubs](#)," Jan 2000).

Happy bargain hunting!

Bob Djurdjevic

EDS Business Trends
2004 revenues flat; 2005 decline 0.5%




Source: Annex Research



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