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Economic Research

AMAT's 2Q06 CEFA Projections Improve; Still Below Consensus and Guidance

Companies Mentioned

Not Rated Companies

Applied Materials (AMAT, $19.05)

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Summary:

Inside the Numbers: We applied March 2006 data from the Commerce Department to our CEFA model to arrive at a new estimate for Applied Materials revenues. We found that Applied Materials is now tracking only slightly below both company guidance and consensus. This is an improvement from our April 10th report, which was based on only the February data, in which we argued that the company was tracking significantly below guidance and consensus. Having only two months of data, we used various assumptions for the third month of the quarter.

Key Points:

- **Data Source:** The Census Bureau's March 2006 Report on Manufacturers' Shipments, Inventories and Orders, released on Wednesday, May 3, 2006, at 10 AM EDT.
- **Data Used:** Industrial machinery shipments were up 9.9% m/m; shipments of computer storage devices were up 11% m/m; and new orders for industrial machinery were up 21% m/m. (The Industrial Machinery category is slightly misnamed. Please see our April 10, 2006 report *AMAT 2Q06 Tracking Below Guidance* for a detailed explanation).
- **Companies Reviewed:** Applied Materials (AMAT)
- **Implications:** Even when using the most optimistic estimates for the third month of the quarter, for which there is no data, we still have found that Applied Materials is tracking below guidance and consensus.
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Analysis

Introduction

On April 10th, we argued: "Applied material's 2Q06 (ending in April) revenue is tracking below the company's guidance and consensus expectations" (Economic Research – *AMAT 2Q06 Tracking Below Guidance: CEFA Industrial Machinery Data Read-Through*, April 10, 2006). In that report, we formally introduced our CEFA model, which tracks the revenues of Applied Material based on governmental economic data.

In that report, we pointed out that our estimates were based only on data for the first month of the company's fiscal April quarter, February, and that the March data would be forthcoming prior to the earning release. We wrote: "As new data becomes available, we will continue to update our model and report when the data reports some deviation from expectations."

Last week, the Census Bureau released its March 2006 Report on Manufacturers Shipments, Inventories and Orders and provided us with a new data that we used to update our model. Upon review of the new data, we found that Applied Materials is now tracking only slightly below guidance and expectations, as opposed to significantly below as reported in the April report. However, even using what we feel are the most optimistic assumptions for April, the final month in the quarter, we find that the revenues are tracking below the low end of guidance.

Applied Materials reports earnings on May 16th.

CEFA Revenue Model – Projecting Revenues for Applied Materials

In our April 10th, report we formulated a CEFA model that we believe has a high degree of reliability for projecting the revenues of Applied Materials. In that report we specified the following model:

RevAmat = f (indmachas, storas, indmachnoa, mednoa, elecufa)
Where:

RevAmat = actual revenues for applied materials (Y).

indmachas = shipments of Industrial Machinery, seasonally adjusted (X1).

storas = shipments of Computer Storage Devices, adjusted (X2).

indmachnoa = new orders for Industrial Machinery, adjusted (X3).

mednoa = new orders for Electro-Medical Instruments, adjusted (X4).

elecufa = unfilled orders for Electronic Components (X5).

Method Used for Projection of Results:

Given that we only have two months of data, we need to estimate the third month before we can make a revenue projection for 2Q06. We began with the hypothesis that the third month of the quarter is often the most active, both for new orders and for product shipments. We tested this hypothesis and determined that from 1Q04 to the present this was in fact correct. We found: (1) New orders on average were up 2.6% over the prior month; and (2) Shipments on average were up 4.4% over the prior month.

We used these estimates for new orders and shipments as our expected estimate. For our high estimate, we looked at the difference between month 2 and month 3 of the quarters in the last two years of the government data and used the highest figures. For new orders the greatest difference between month 2 and 3 in any quarter was 32.7%, and for shipments it was 13.5%. We used these numbers, which were well above the averages, for our 2Q06 high estimate.

Results

Our low estimate for 2Q06 revenues was $1,935 million and our high estimate produced revenues of $2,014 million. Guidance from the company suggested that would come in between $2,099 and $2,136 million (February 15, 2006 conference call), while the consensus is for revenues between $2,099 and $2200 (First Call, May 5, 2006). The results, consolidated in Table 1, show that we are still projecting revenues to come in below the low end of guidance and consensus.

Table 1: Applied Materials 2Q06 Revenue Estimates: NYGS, Guidance and Consensus ($MM)

	Low	High
NYGS CEFA Model	1,935	2,014
Company Guidance	2,099	2,136
Consensus	2,099	2,200

Source: NYGS Research, Company Reports, Thomson Financial and the Department of Commerce.

Table 2 below provides summary results from the CEFA Model as it applies to Applied Materials. Running our model from 2002 through last quarter we found that our average revenue difference versus actual is $52 million, with a standard deviation of $31 million. This indicates statistically that 82% of the time our estimate will be within $52 million, assuming that we had all three months of data. Unfortunately, we have only two months of data going into each earnings period, and for this reason we are required to project the third month of data.

Table 2: Applied Materials Revenues: Actual and CEFA Model Results ($MM)

Quarter	Actual	CEFA Model	Difference
2002-1	1000	1086	86
2002-2	1156	1050	106
2002-3	1460	1447	13
2002-4	1446	1391	55
2003-1	1054	1105	51
2003-2	1107	1138	31
2003-3	1095	1112	17
2003-4	1221	1161	60
2004-1	1556	1513	43
2004-2	2018	2090	72
2004-3	2236	2237	1
2004-4	2203	2131	72
2005-1	1781	1717	64
2005-2	1861	1754	107
2005-3	1632	1650	18
2005-4	1718	1758	40
2006-1	1857	1910	53
Average Difference			**52**
Standard Deviation			**31**

Source: NYGS Research, company reports and the Department of Commerce.

Conclusion

Using our CEFA model we found that our revenue projections for Applied Materials are still tracking below guidance. Based on our estimates, we are looking for revenue growth of 4-9% q/q, as opposed to guidance of 13-15%, and consensus of 13-17%.

Risk Factors

Our CEFA model is purely a statistical model based on actual data provided by the government. We are projecting a single company's revenues from data that is collected from a large group of companies. We are then applying this data to a single company based on a statistical factor model designed to determine statistical validity of the data to the specific company. This approach may prove to be invalid. The model, which has worked in the past, provides no guarantee that it will work in the future, and if anything it is expected that the further in time from the original specification of the model the worse the results will be. In this respect, the model requires constant attention.

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