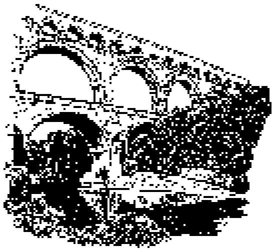


Stanley E. Rulapaugh, CFA **March 31, 2002**

"What the fat boy in the canoe does makes a difference to everybody else."

Dean Rusk, President. Rockefeller Foundation 1952 - 1961

OK, so it's not politically correct but it is appropriate for this letter. During the quarter shareholders voted on the Hewlett-Packard / Compaq merger. As I write this, the Hatfields are still feuding with the McCoys, each side accusing the other of some sort of chicanery in the voting process. Whatever the outcome, this deal is a loser as I predicted in my October 1, 2001 letter. A recent Merrill Lynch report on Dell Computer convinced me even more.

Merrill's March 6 report, written by analysts Steven Fortuna and Michael Hellmeyer, followed a visit to Dell's headquarters near Austin, Texas. They made the following observations about their tour of Dell's OptiPlex factory where all of the North American corporate desktop computers are manufactured. For me there is just one "wow!" after another in these four paragraphs.

> The OptiPlex factory is a textbook case of just-in-time manufacturing. Dell only keeps around six hours of raw materials inventory on hand in the factory, with the goal of reducing this to three hours by the end of the year. Parts needed for the assembly of PCs are ordered from suppliers every two hours and arrive within 90 minutes. In fact, Dell's factory management software is tightly integrated with the systems of its suppliers. Dell hasn't been resting on its laurels here with factory output currently at 600 units per hour, up from the 400 units per hour level it was during our visit last year. The original level at the factory was only 90 units per hour.
>
> While Dell has agreements with its suppliers to buy inventory , there are no set levels for price or timing. Dell pays market price as goods enter one of its factories (including for DRAM memory chips). If component pricing rises, Dell can be at a disadvantage, but this is typically short-lived . . .
>
> Today, Dell ships 95% of its orders within five days. Dell's overall inventory is now at around four days with the goal of hitting three days fairly soon. Dell hopes to eventually get this down to two days. Note that these totals include service parts and returns . . .
>
> Labor is a very small percentage of the cost of each system - maybe \$10 - \$15 per box. Fixed costs in general are a small percentage of total costs, less than 2%.

Henry Ford may get credit for inventing the assembly line but Michael Dell perfected it. I checked the annual reports for both Hewlett-Packard and Dell to learn how much inventory each company held at the end of the latest year reported. I divided the "inventory" figure into "cost of goods sold" which produced "inventory turnover" for both companies. A high inventory turnover number means that the company is selling goods fast enough that they won't get stuck with obsolete inventory or pricing problems. A low number means inefficiency, pricing vulnerability and expensive storage. HP turns over their inventory five times per year. Dell turns it over <u>92</u> times per year. Dell has only four days' sales in inventory. HP has 70 days' sales in inventory. These numbers are important for the profitability of each company. If Dell makes a dime each time it turns over its inventory, it makes \$9.20. HP has to make \$1.84 on each inventory turn to earn \$9.20. Therefore, HP has far less pricing flexibility than Dell in addition to the added risk of product obsolescence. HP's concentration on Compaq will give Dell even more time to improve production and pricing efficiencies. There are two more lines I want to include from the Merrill Lynch report.

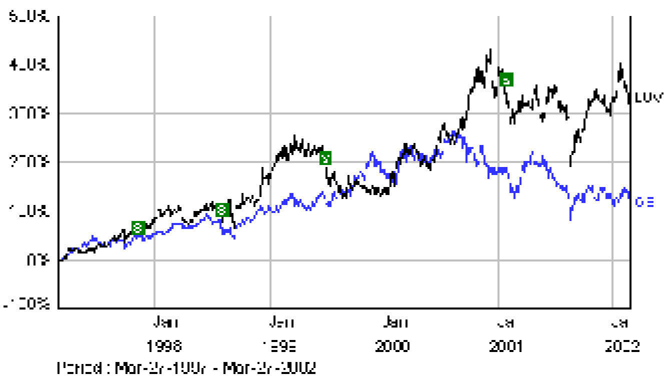
> Dell is focusing more on Lexmark printers now rather than HP. Dell doesn't want to sell HP printers but will if customers request them.

It appears that Dell knows it has a winning formula in computers and does not want to support its arch rival in printers, the arch rival's most profitable product area. Brilliant. HP's chairman, Carly Fiorina, made the following comment at the February 4 Goldman Sachs Technology Conference.

> We had choices in our PC business. We could shut it down, which would damage our imaging and printing franchise and mean significant loss of jobs. We could spin it off, as some people have suggested. But, frankly, *our PC business is not a viable entity in its own right* and would not create sufficient value for share owners. Or, alternatively, we could fix it by adding volume and direct distribution capabilities. (Emphasis added.)

Let's see if I have this right. They lose money in the PC business so they are going to make it up by adding volume. That is an old joke but this strategy may have serious consequences for HP shareholders if it fails. HP cannot compete with Dell on Dell's terms. That is why I recommended that clients vote against the Compaq acquisition. If the acquisition is approved, I will recommend that clients sell the stock.

This may sound like a commercial for Dell stock. (Full disclosure. I do own it.) It's not. It is a commercial for investing in the strongest competitor, the "fat boy in the boat." I also own Southwest Airlines. Consider the attached 5-year chart comparing Southwest (LUV) to one of America's most-loved companies, General Electric (GE). Even professional investors are surprised to learn that an airline has been a better investment than GE. And it has been for almost any time period you pick, from ten years to as short as one month.



I was struck by Southwest's February traffic report since we all know that the September 11 attacks had a catastrophic effect on air travel. This is from Southwest's press release.

> . . . the company flew 3.2 billion revenue passenger miles in February 2002, a 4.4 percent decrease from the 3.3 billion flown in February 2001 . . . The load factor for the month was 61.2 percent, compared to 66.9 percent for the same period last year.

When you consider that every other airline cut the number of flights, parked airplanes, and laid off thousands of employees, for LUV to be down only a few percent is remarkable. Southwest continued to fly all of their routes after 9/11 and maintained full employment. They recently announced plans to add more than two thousand employees because business is so good. The others? My own fearless forecast is that America West won't survive. That leaves Southwest as the dominant airline in the Phoenix area and in the West. United, American and Delta are losing millions every month. They may survive but in a reduced configuration. That allows Southwest to grow into new airports.

Both Dell and Southwest have one thing in common - they are able to make money while most of their competitors are losing money. They may not make much, but they do make it. As competitors drop off because they can't compete, Dell and Southwest will grow stronger. These two examples illustrate that management does make a difference regardless of the business. Ford Motor should hope Dell doesn't decide to make automobiles.

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