

**Eastman Kodak Co.**  
**EK - \$32.95 – NYSE**

**Rating: 5**

**Recommendation: Sell Short**

**Reasons For Recommendation**

- **Stagnant revenue growth.**
- **Extremely low quality of earnings.**
- **Quarter after quarter of “Restructuring Charges”**
- **Business going from 60% gross margin photography business to 20% gross margin digital hardware business against deep Japanese competition.**
- **2005 EPS estimate flat with 2004’s \$2.54**

**Financials**

52 – Week Low 12-16-200	\$ 23.19	Book Value (mrq)	\$13.25
52 – Week high 10-6-2004	\$34.74	Earnings/Shr (ttm)	\$0.736
Daily Volume Avg.	4.09M	Earnings/Shr (mrq)	\$0.16
52 – Week Change	+29.58%	Sales/Shr (ttm)	\$47.19
Market Capitalization	\$9.40B	Cash/Shr (mrq)	\$3.88
Shares Outstanding	286.61M	Price/Book (mrq)	2.47
Float	286.0M	Price/Earnings (ttm)	44.57
Profit Margin (ttm)	1.56%	Price/Sales (ttm)	0.67
Operating Margin (ttm)	1.36%	Revenue (ttm)	\$13.53B
Return on Assets (ttm)	1.44%	EBITDA (ttm)	\$1.05B
Return on Equity (ttm)	6.41%	Income to common (ttm)	\$211.0M
Current Ratio (mrq)	1.11	Shares Short 4-8-03	19.38M
Debt/Equity (mrq)	0.703	% of Float Short	6.78%
Total Cash (mrq)	\$1.11B	Short Ratio	5.71

(ttm) = Trailing 12 months, (mrq) = Most recent quarter, K = Thousands, M = Millions, B = Billions

## Business Description

Eastman Kodak Company is engaged primarily in developing, manufacturing and marketing traditional and digital imaging products, services and solutions to consumers, the entertainment industry, professionals, healthcare providers and other customers. The Company's products are marketed and sold throughout the world. For 2003, **Kodak organized its business into four segments: Photography, Health Imaging, Commercial Imaging and All Other.** The Photography segment derives revenues from consumer film products, sales of origination and print film to the entertainment industry, sales of professional film products, traditional and inkjet photo paper, chemicals, traditional and digital cameras, photo processing equipment and services and digitization services, including online services. The Health Imaging segment derives revenues from the sale of digital products, including laser imagers, media, computed and direct radiography equipment and healthcare information systems, as well as traditional medical products, including analog film, equipment, chemistry, services and specialty products for the mammography, oncology and dental fields. The Commercial Imaging segment derives revenues from microfilm equipment and media, wide-format inkjet printers, inks and media, scanners and other business equipment sold to commercial and government customers; long-term government contracts, and graphics film products sold to the Kodak Polychrome Graphics joint venture. The All Other group derives revenues from the sale of organic light-emitting diode (OLED) displays, imaging sensor solutions and optical products to other manufacturers.

### Photography

The Photography segment includes digital and traditional products for consumers, professional photographers and the entertainment industry. This segment combines digital and traditional photography and photographic services in all its forms, including consumer, advanced amateur, professional and motion picture. Kodak manufactures and markets films (consumer, professional and motion picture), photographic papers, processing services, photofinishing equipment, photographic chemicals and cameras (including one-time-use, traditional and digital). Kodak has also developed products that bridge traditional silver halide and digital products. Products and services include kiosks, printer docks, consumer digital services and inkjet media. Other digitization options have been created to stimulate more pictures in the use and printing of these images, adding to the consumption of film and paper. These products serve amateur photographers, as well as professional, motion picture and television customers. In addition, Ofoto, Inc. has accelerated Kodak's growth in the online photography market and helped to drive more rapid adoption of digital and online services. Ofoto offers digital processing of digital images and traditional film, prints, private online image storage, sharing, editing and creative tools, frames, cards, photo calendars and other merchandise.

In June 2003, the Company completed its acquisition of Applied Science Fiction's proprietary rapid film processing technology and other assets. In October 2003, Kodak completed its acquisition of Laser-Pacific Media Corporation, a post-production company.

## **Health Imaging**

Products and services of the Health Imaging segment enable healthcare customers (such as hospitals, imaging centers and others) to capture, process, integrate, archive and display images and information in a variety of forms. These products and services provide intelligent decision support through the entire patient pathway from research to detection to diagnosis to treatment. The Health Imaging segment also provides products and services that help customers improve workflow and productivity in their facilities, which, in turn, helps them enhance the quality and productivity of healthcare delivery.

Products of the Health Imaging segment include traditional analog medical films, chemicals and processing equipment. Kodak's history in traditional analog imaging has served as the foundation for building its important digital imaging business. The segment provides digital medical imaging and information products, systems and solutions, which are key components of future sales and earnings growth. These include digital print films, laser imagers, computed and digital radiography systems and healthcare information systems (HCIS). The Health Imaging segment serves the general radiology market and specialty health markets, including dental, mammography and oncology. The segment also provides molecular imaging for the biotechnology research market.

In October 2003, Kodak completed the acquisition of all of the outstanding shares of PracticeWorks, Inc., a provider of dental practice management software. In the purchase, Kodak also acquired PracticeWorks' subsidiary, Trophy Radiologie, S. A., a provider of dental digital radiographic imaging systems in Paris, France. In November 2003, the Company completed the acquisition of Algotec Systems, Ltd., a developer of advanced picture archiving and communications systems.

## **Commercial Imaging**

As of and for 2003, the Commercial Imaging segment encompassed Kodak's expertise in imaging solutions, providing image capture, analysis, printing and archiving. Markets for the segment include commercial printing and industrial, banking and insurance applications. Products include high-speed digital printing equipment, wide-format inkjet printers, inks, media and services, high-speed production document scanners, micrographic peripherals and aerial, industrial, graphic and micrographic films. The Company also provides maintenance and professional services for Kodak and other manufacturers' products, as well as providing imaging services to customers.

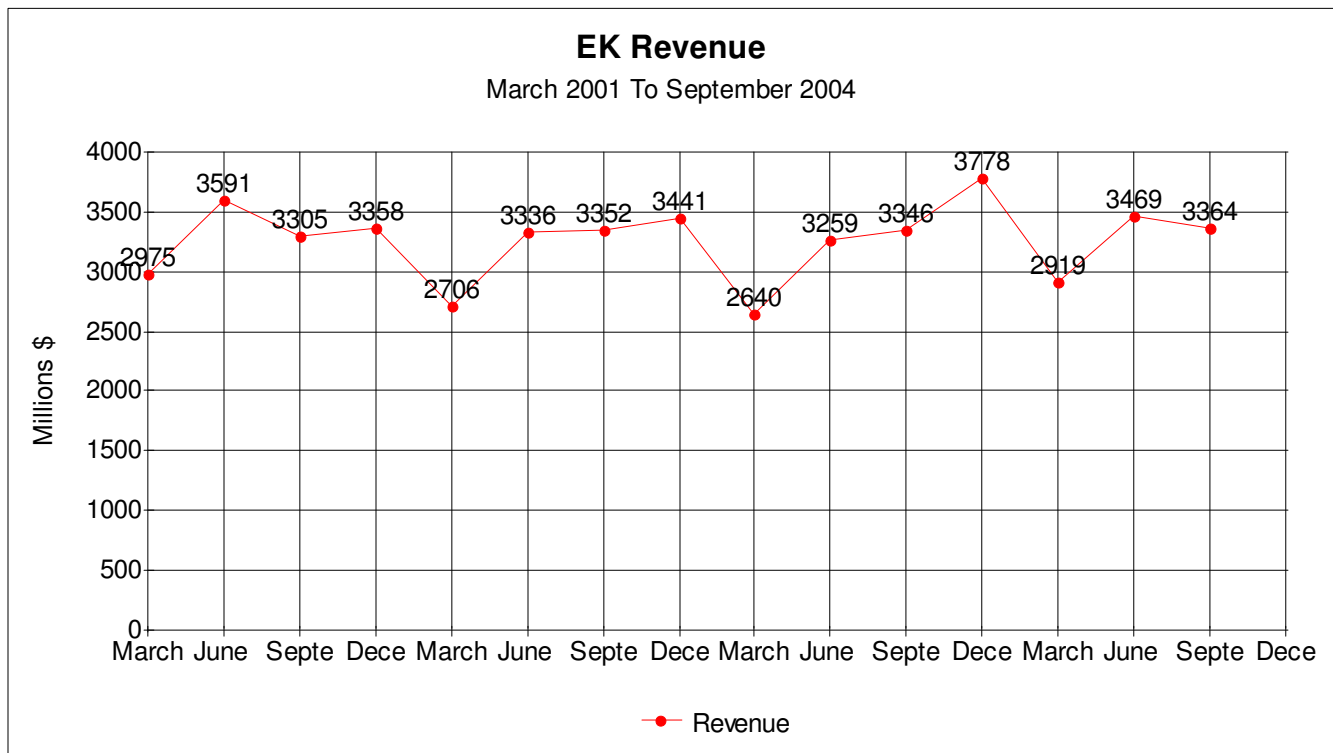
This segment includes the Company's equity interests in Kodak Polychrome Graphics LLC (KPG) and NexPress Solutions LLC, which both serve commercial printing customers. KPG is an unconsolidated joint venture between Kodak and Sun Chemical Corporation in which Kodak owns a 50% interest. This joint venture is responsible for the photographic plate business, as well as for marketing Kodak graphic arts film, proofing materials and equipment. NexPress is an unconsolidated joint venture between Kodak and Heidelberger Druckmaschinen AG in which Kodak owns a 50% interest that was formed for the purpose of developing and marketing new digital color printing solutions.

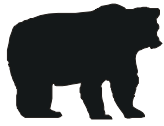


## All Other

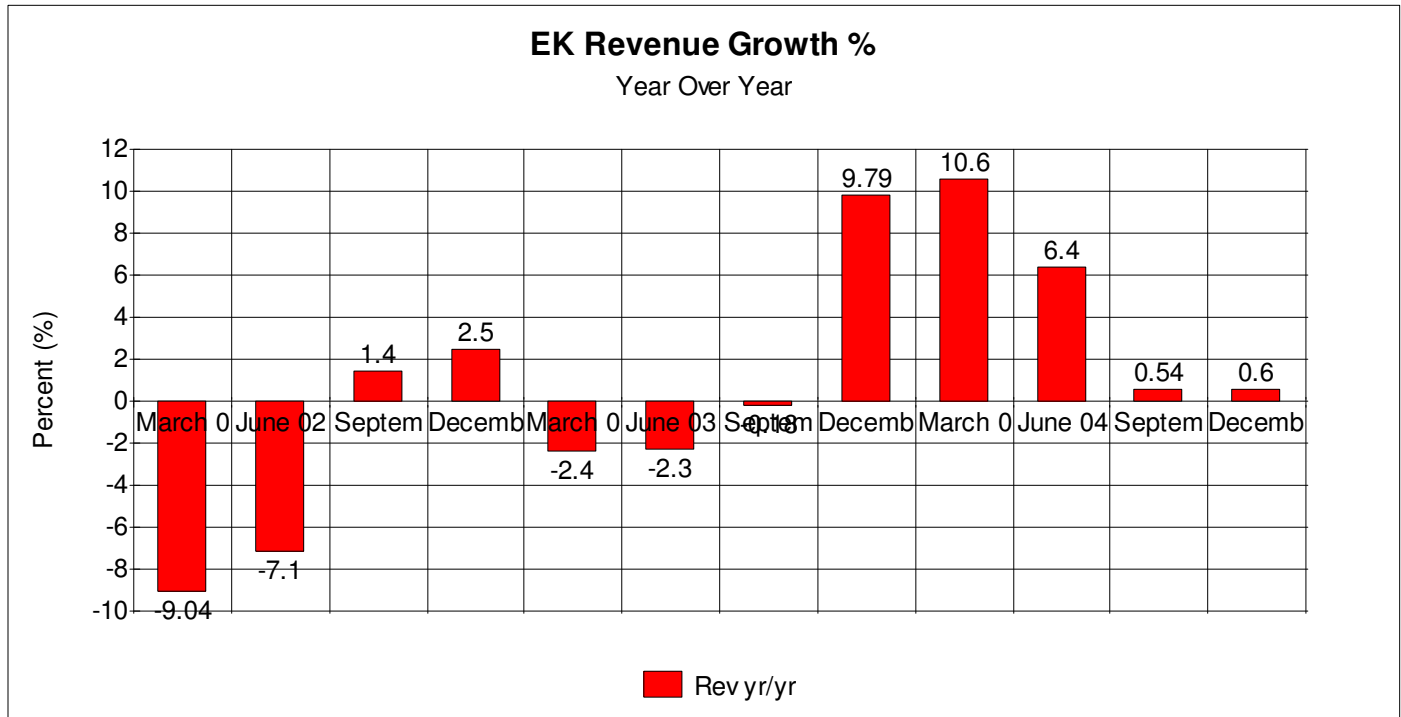
All Other consists primarily of the Kodak components group, which represents an effort by Kodak to diversify into high-growth product areas that are consistent with the Company's historical strengths in imaging science. The Kodak components group consists of the Kodak display business, the imaging sensor solutions business and an optics business. Products of this group include OLED displays, imaging sensor solutions and optics and optical systems. In 2001, the Company and SANYO Electric Co., Ltd. established a global business venture, the SK Display Corporation, to manufacture OLED displays for consumer devices such as cameras, PDAs and portable entertainment machines. Kodak holds a 34% ownership interest and SANYO holds a 66% interest in the business venture.

## Stagnant Revenue Growth





As you can see from the previous chart, Eastman Kodak (EK) has had stagnant revenue growth for the past four years. Revenue for the past three years beginning in 2001 was \$13.2 billion, \$12.8 billion in 2002, and \$13.0 billion in 2003. Revenue for 2004 ending in December is estimated to be \$13.5 billion. Revenue for next year, 2005, is estimated to be \$13.8 billion or growth of 2%. Clearly, this is not a growing company on a revenue basis.



On a year over year basis, revenue growth is also going nowhere. Historically, the December quarter is the biggest quarter of the year for revenue. This year's (2004) fourth quarter revenue of \$3.8 billion is estimated to grow only 0.6% versus last years fourth quarter revenue of \$3.77 billion.

Why is Eastman Kodak struggling to grow revenue every year? Because its' main business of photography has been undergoing a permanent shift from standard film developing to digital photography. This shift has been difficult, long and is still underway.



## **High Gross Margin To Low Gross Margin Business**

Since photography became popular with the general public, EK was the undisputed leader. Not until Fuji entered the photography paper business did Kodak have any real competition. With the old 35mm camera's, you needed to buy film and then after you took a roll of pictures you needed to get them developed. Both the film and the development were expensive. Kodak had a good business supplying these items to the general public. Then along came the digital age.

When digital cameras first came out several years ago, they were expensive and generally not very good. But as in all things digital, the prices rapidly came down for the cameras and also for the memory cards that you need to take the pictures on. In 2004 for the first time ever, sales of digital cameras overtook sales of conventional 35mm cameras. Kodak is trying to make the transition to the digital world.

The conventional 35mm camera business was a high gross margin business with margins around 60%. There was also much less competition. Today the digital camera business is a low gross margin business, around 20%, with much more competition from many deep pocket competitors. EK now competes head on with many Japanese companies in the hardware business. In the electronics industry, everything that has gone digital has been characterized by rapid declines in hardware prices. Many companies have gone bankrupt trying to compete in these low margin businesses that at first had higher gross margins.

For example, take a look at the standard television industry. Badger Consultants very first sell short recommendation was a company named Zenith Electronics. Zenith made TV's. That business was characterized by a decade of price declines in the prices of televisions with many competitors. Zenith went bankrupt. The same exact thing happened in the VCR industry. When VCR's first appeared they were around \$1,000. Today you can buy a VCR for around \$40.

We believe that the same scenario is already playing out in the photography business. It is already clear that the prices of digital cameras have come down substantially. A few years ago digital cameras were around \$1,000. Today you can buy a good digital camera together with a large memory card for around \$250.

There is also another huge difference. When you bought a 35mm camera, if you wanted to view the pictures you had to pay the \$7 to get the pictures developed. Kodak earned a profit from that \$7. Also, you needed to make two trips to the store. One to drop off the film and another to pick up the film after it had been developed. That gave Kodak two more opportunities to sell you additional products.

Today, many people never print out the pictures that they take with their digital cameras. They just view them on the computer or e-mail them to friends and family. Personally, I am on my second digital camera. I have taken hundreds and hundreds of pictures. I have only printed out a handful. The camera and printer companies are launching an all out attempt to try and change this habit. They are selling printers specifically designed to print out pictures straight from the memory card with no computer needed.



The companies are trying this approach because they do not make any money when all you do is e-mail a picture or just view it on a PC or television. If they can convince consumers to print their own pictures, then they can sell you the printer, ink and photo paper. Kodak also has an online digital photo business Ofoto. You can make albums of your digital pictures and share them with your friends and family. They can then order any of your pictures from Kodak.

We do not believe that any of these businesses will come close to replacing Kodak's old business of film development. There are just too many competitors and the price competition is brutal. Kodak has recently gained market share in the sale of digital cameras by lowering prices. Lowering prices is just about the only way to increase business. Lowering prices never increases gross margins.

"U.S. shipments of digital cameras rose 40 percent in the third quarter from a year ago, with Eastman Kodak Co. gaining market share on Sony Corp. according to an industry study.

Third quarter shipments rose to 5 million units, up from 4.5 million in the second quarter and 3.6 million units a year earlier, according to research firm IDC's "U.S. Digital Camera Market Share Review."

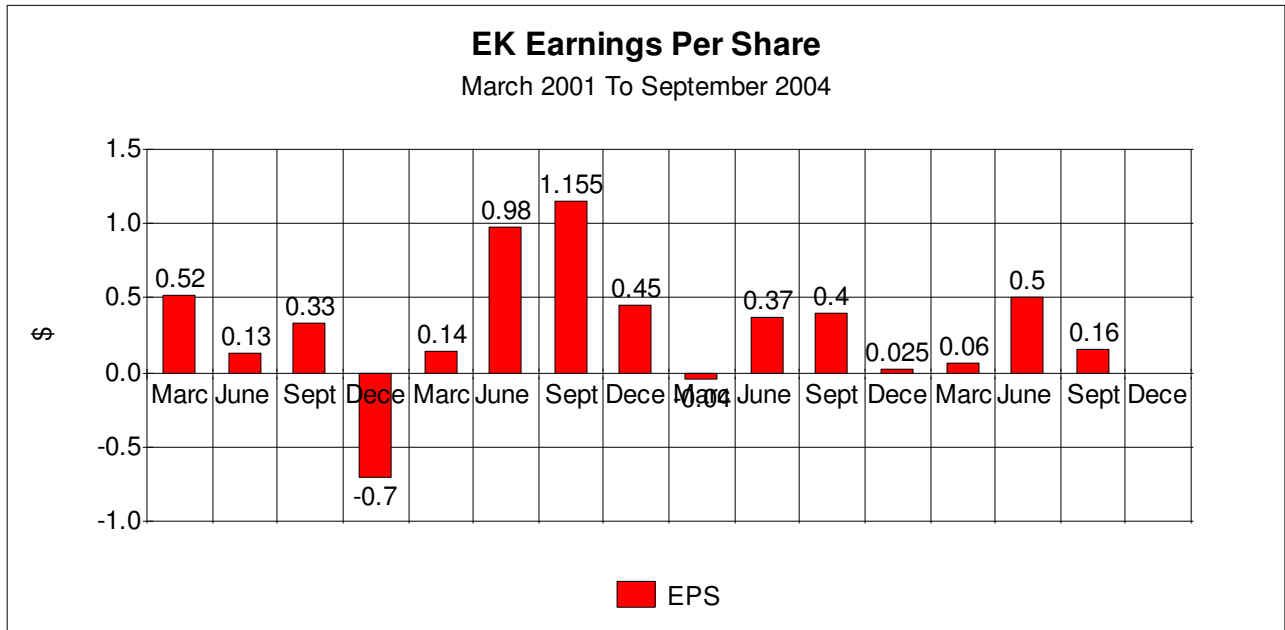
Sony and Kodak were nearly tied for first place, with Sony at 20 percent and Kodak at 19.8 percent. In the second quarter Sony had a 22 percent share, to Kodak's 18.3 percent.

Kodak, which has been undergoing a tough transition to digital products and services and away from its flagging traditional camera and film business, had gained ground on rival camera makers with its lower priced models.

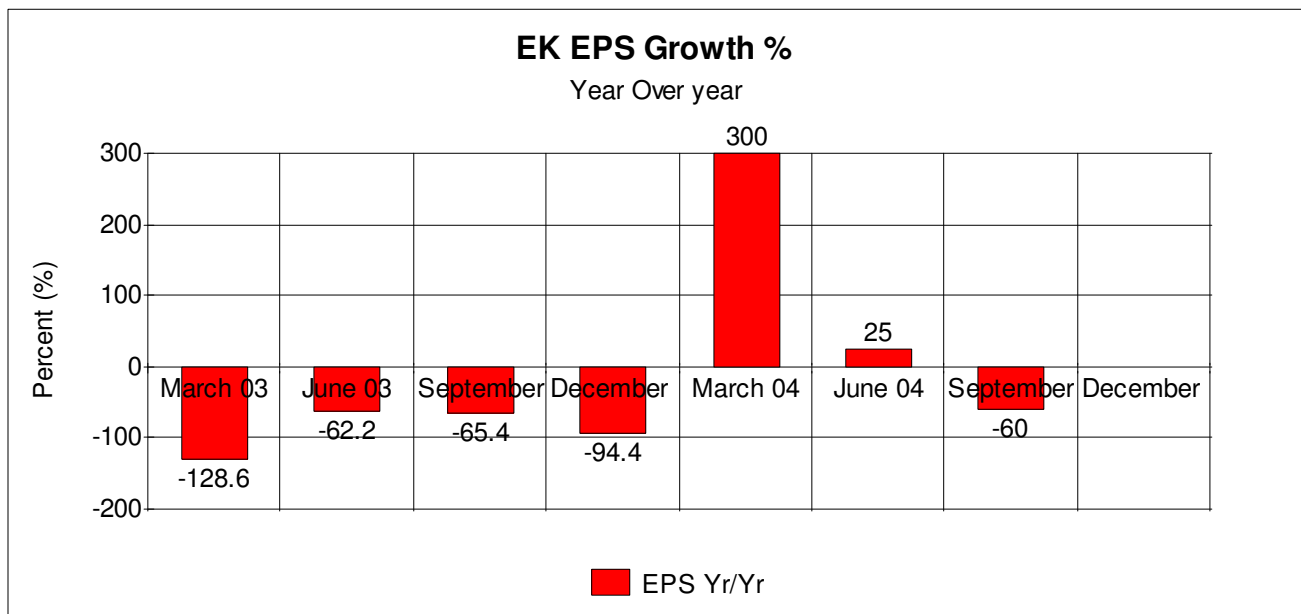
In third and fourth place were Japan's Canon Inc. with a 16 percent share and Olympus Corp. with a 12 percent share, IDC said.

While the total 40 percent rise is better than that of most other consumer electronics devices, growth in the period, which includes back-to-school shopping, was slower than the second quarter's year-over-year gain of 42.5 percent. IDC said that there are fewer first-time buyers of digital cameras.

"IDC believes that close to 1 out of every 2 digital camera purchases are by current owners, thus restricting the increased penetration of digital cameras into new households," IDC said."



Earnings per share have been all over the map despite revenue being relatively flat for the past sixteen quarters. There have been nine quarters in a row of one-time restructuring charges. This is a big red flag and raises serious questions about the quality of earnings at EK. There have been so many non-recurring charges that we are not sure exactly how much EK really earns. What we do know is that the company is not growing revenue and that the price declines in its main business are continuing. Therefore we anticipate more restructuring charges in the future.





EK's sales growth for the last 5 years is -0.13%. For the past 3 years it is -1.64%. For the past 1 year it is 3.76%. EK's earnings per share growth for the past 5 years is -27.8%. For the past 3 years it is -43.5%. For the past year it is -69.5%

**GROWTH RATES**

	<b>1 Year</b>	<b>3 Years</b>	<b>5 Years</b>
Sales %	3.76	-1.64	-0.13
EPS %	-69.47	-43.45	-27.83
Dividend %	-36.11	-13.23	-8.16

**REVENUE**

<b>Quarters</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>
MAR	2,975	2,706	2,640	2,919
JUN	3,591	3,336	3,259	3,469
SEP	3,305	3,352	3,346	3,364
DEC	3,358	3,441	3,778	
<b>Totals</b>	<b>13,229</b>	<b>12,835</b>	<b>13,023</b>	<b>9,752</b>

**Note:** Units in Millions of U.S. Dollars

**EARNINGS PER SHARE**

<b>Quarters</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>
MAR	0.520	0.140	-0.040	0.060
JUN	0.130	0.980	0.370	0.500
SEP	0.330	1.155	0.400	0.160
DEC	-0.700	0.450	0.025	
<b>Totals</b>	<b>0.280</b>	<b>2.725</b>	<b>0.755</b>	<b>0.720</b>

**Note:** Units in U.S. Dollars



We believe that EK is a dinosaur stodgy old company trying to reinvent itself as a digital company. With the recent increase in the stock price we are recommending investors sell short EK. The stock has been in a gradual decline for the past five years and we will use this increase in price to initiate coverage. Our price target is \$22 within one year.