Evaluating Intel's Earnings Torpedo[1]

On September 21, 2000, Intel Corporation, the world's largest manufacturer of computer chips, issued an earnings warning indicating that third-quarter revenue was anticipated to be below previous expectations. This announcement prompted a huge sell-off in Intel's stock, which drove the price down from $61.48 to $47.94 over the course of the next 24 hours. This 22 percent stock price drop took place on daily volume of 300 million shares, a new record for the NASDAQ. In this case, you will build pro forma financial statements for Intel based on both Wall Street's expectations prior to Intel's earnings warning and Wall Street's revised expectations after the warning. You will then evaluate whether Intel's stock price decline was justified by the information in the earnings warning.

Intel's revenue growth was 11.9 percent in 1999 and had grown at an average annual rate of just over 12.5 percent for the five years ending in 1999. A surge in the worldwide demand for computer chips resulted in strong revenue growth in the first two quarters of 2000, with year-over-year revenue growth for the first and second quarter of 12.5 percent and 23.0 percent, respectively. In the press release accompanying the announcement of the financial results for the second quarter, Craig Barrett, president and CEO of Intel, stated that "looking forward, we expect to see strong demand continue into the second half." Based on this guidance, most Wall Street analysts were expecting Intel's third-quarter revenue to be between $8.8 million and $9.3 million, representing year-over-year quarterly growth of between 20 and 27 percent, and sequential quarterly growth of between 6 and 12 percent.

Intel released its earnings warning after the close of regular trading hours on September 21, 2000. The full text of the press release is attached as Exhibit 1. In this press release, Intel indicated that it "now expects revenue growth for the third quarter to be approximately 3 to 5 percent higher than second quarter revenue of $8.3 billion."

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[1] This case was prepared by Richard G. Sloan, Professor of Accounting at the University of Michigan Business School, for the purpose of class discussion, rather than to indicate the effective or ineffective handling of a business situation.

EXHIBIT 1
Intel Third-Quarter Revenue to Be Below Expectations
Demand in Europe weaker than expected.

SANTA CLARA, Calif., Sept. 21, 2000—Intel's third quarter revenue is anticipated to be below the company's previous expectations, primarily due to weaker demand in Europe, the company said today. The company now expects revenue for the third quarter to be approximately 3 to 5 percent higher than second quarter revenue of $8.3 billion.

The company expects gross margin percentage for the third quarter to be 62 percent, plus or minus a point, lower than the company's previous expectations of approximately 63 to 64 percent. Interest and other is expected to be approximately $900 million for the third quarter, up from the company's previous expectations of $800 million.

Business Outlook

The following statements are based on current expectations. These statements are forward-looking, and actual results may differ materially. These statements do not reflect the potential impact of any mergers or acquisitions that may be completed after the date of this release.

- The company expects revenue for the third quarter of 2000 to be approximately 3 to 5 percent higher than second quarter revenue of $8.3 billion.
- The company expects gross margin percentage for the third quarter to be 62 percent, plus or minus a point. Gross margin percentage for 2000 is expected to be 63 percent, plus or minus a few points. In the short term, Intel's gross margin percentage varies primarily with revenue levels and product mix as well as changes in unit costs.
- Expenses (R&D, excluding in-process R&D, plus MG&A) in the third quarter of 2000 are expected to be up 7 to 9 percent from second quarter expenses of $2.2 billion, primarily due to higher spending on marketing programs and R&D initiatives in new business areas. Expenses are dependent in part on the level of revenue.
- R&D spending, excluding in-process R&D, is expected to be approximately $4.0 billion for 2000.
- The company expects interest and other income for the third quarter of 2000 to be approximately $900 million. Interest and other is dependent in part on interest rates, cash balances, equity market levels and volatility, the realization of expected gains on investments, including gains on investments acquired by third parties, and assuming no unanticipated items.
- The tax rate for 2000 is expected to be approximately 31.8 percent, excluding the impact of the previously announced agreement with the Internal Revenue Service and acquisition-related costs.
- Capital spending for 2000 is expected to be approximately $6.0 billion.
- Depreciation is expected to be approximately $790 million in the third quarter and $3.4 billion for the full year 2000.
- Amortization of goodwill and other acquisition-related intangibles is expected to be approximately $400 million in the third quarter and $1.5 billion for the full year 2000.

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EXHIBIT 1
Intel Third-Quarter Revenue to Be Below Expectations *(continued)*

Copies of this earnings release and Intel's annual report can be obtained via the Internet at http://www.intc.com/ or by calling Intel's transfer agent, Computershare Investor Services, L.L.C. (formerly named Harris Trust and Savings Bank), at (800) 298-0146.

Intel, the world's largest chip maker, is also a leading manufacturer of computer, networking and communications products.

The above statements contained in this outlook are forward-looking statements that involve a number of risks and uncertainties. In addition to factors discussed above, among other factors that could cause actual results to differ materially are the following: business and economic conditions and growth in the computing industry in various geographic regions; changes in customer order patterns; changes in the mixes of microprocessor types and speeds, purchased components and other products; competitive factors, such as rival chip architectures and manufacturing technologies, competing software-compatible microprocessors and acceptance of new products in specific market segments; pricing pressures; development and timing of introduction of compelling software applications; insufficient, excess or obsolete inventory and variations in inventory valuation; continued success in technological advances, including development and implementation of new processes and strategic products for specific market segments; execution of the manufacturing ramp, including the transition to the 0.18-micron process technology; shortage of manufacturing capacity; the ability to grow new networking, communications, wireless and other Internet-related businesses and successfully integrate and operate any acquired businesses; unanticipated costs or other adverse effects associated with processors and other products containing errata (deviations from published specifications); litigation involving antitrust, intellectual property, consumer and other issues; and other risk factors listed from time to time in the company's SEC reports, including but not limited to the report on Form 10-Q for the quarter ended July 1, 2000 (Part I, Item 2, Outlook section).

Based on the information provided above and using the *eVal* software to facilitate your analysis, perform the following tasks:

1. Import the data for this case into *eVal*. (Note: case data can be imported by going to the Case Data sheet in *eVal* and selecting the yellow block of data for the company, and then pasting this block of data into the yellow cells at the bottom of the Financial Statements sheet using Paste Special - Values from the Edit menu.)
2. For the purpose of this case, you should set the valuation date to September 22, 2000, and the cost of equity capital to 12 percent on the Valuation Parameters worksheet.
3. Based on Wall Street's expectations immediately *before* Intel's earnings warning, provide a set of forecasting assumptions that (approximately) justify Intel's $61.48 pre-warning stock price.
4. Based on Wall Street's expectations immediately *after* Intel's earnings warning, provide a set of forecasting assumptions that (approximately) justify Intel's $47.94 post-warning stock price.
5. Based on your analysis in questions one through three, evaluate whether the 22 percent stock price drop was a reasonable response to the news about valuation fundamentals in Intel's earnings warning. To the extent that you do not think the stock price drop was justified, speculate as to why it occurred.