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A Good Sweating

When John D. Rockefeller set out to dominate the oil industry, it was a chaotic, fragmented industry. Rockefeller realized that the only way to stabilize the industry was by dominating it and the only way to do that was to either buy out all the competitors or otherwise find a way to make them toe the line. One of his favored methods was to give competitors "a good sweating." A good sweating consisted in lowering prices in selected markets to such an extent that all competitors either went broke, sold out to Standard Oil or otherwise agreed to abide by the rules set forth by Standard Oil, i.e. John D. Rockefeller.

Of course, eventually this was found to be illegal, monopolistic and Standard Oil was forbidden to set prices. The oil industry went back to its earlier chaotic state and a government office, the Texas Railway Commission, took over the job of fixing oil prices. But that's not the point of this post.

The history of data processing is the other way around. The first computers were specifically built for specific jobs. As they got faster and cheaper they reached into new markets. They moved from the data center to the individual corporate departments, to the workers' desktops and their homes and now they are moving into just about everything. At each stage the computers took over jobs that earlier were done by different

means. In the latest round, moving into the embedded market, the System on a Chip is changing the way engineers build products. Instead of designing hardware they now write software -- up to a point anyway. At an early stage, before path dependence has set in, whoever wants to control the market has to follow John D. Rockefeller's example and give competitors a good sweating which is what ARM is doing right now.

I have argued elsewhere that one of the most important elements in a company's success is its management. Anyone who has followed Sir Saxby's career would realize that this is a very competitive man. One of the reasons why he moved from Motorola to ARM was because Motorola would not let him have the top job there. I have a hard time believing that Sir Saxby is not extracting the maximum value that the market will bear at this time.

Where is ARM in its life cycle? Most people on this board agree that ARM is the gorilla in wireless but disagree about its gorillahood in other areas such as set top boxes. ARM is still in the bowling alley in many of its possible markets. How does this affect its ability to extract the maximum price from its cores? One could argue that since ARM is the wireless gorilla it should extract the maximum royalty from the wireless market. But one can also argue that since ARM is still in the bowling alley in many other markets, it should give its competitors in those markets a good sweating so as to win those battles. If ARM made different products for different markets this would not be a

problem. But ARM "essentially" makes the "same" products for all markets so creating a price differential along market lines is not feasible. So ARM is left with a choice, short term success or long term success. By looking at ARM cash hoard we can determine that they have not done badly short term. ARM has profits, positive cash flow and increasing market penetration. On the other hand, ARM is probably not extracting what the market, where it is a gorilla, will bear. The questions are, will ARM become a gorilla in other markets and will then ARM extract what the market will bear in all its markets?

Now we come to the Investor's Dilemma. What will ARM look like two, three or four years down the road? There is ample proof, both empirical and academic, that whoever establishes the early lead tends to set the standard and becomes the market leader. If you believe that wireless is but a small portion of ARM's potential markets then you would want ARM to penetrate these other markets ASAP. If you think that wireless is ARM's final and most important market then ARM should raise royalties ASAP.

Let's do a fast forward to 2008 or 2010. Let's suppose that ARM has become the gorilla in all or in most of its potential markets. Let's further suppose that ARM's market will have demand for another 10 to 20 years. In such a situation, barring something unexpected like a total economic collapse or a 4th World War, ARM's share price will have grown appreciably. People will look back and will say: "Gee, in 2004 ARM was really

cheap. Why didn't I see it then?" Moore's contention that gorillas are always undervalued will have been borne out.

We can do a different fast forward to 2008 or 2010. ARM remains the gorilla of wireless but loses out to MIPS, Intel, Transmeta and Renasas (or whatever it's called) in most other markets. In this second scenario ARM's share price probably tracks the major indexes. People will look back and will say (if they remember at all): "Gee that dumb Denny sure was overly optimistic."

If you have read *The Gorilla Game* you know that none of the above is a problem. You wait for the tornado and then you buy.

Which tornado?

The wireless tornado that no one seems to have seen but which must have happened somehow. The set top box tornado? The automobile tornado? The printer tornado? The digital camera tornado? The RFID reader tornado? The house networking tornado? The embedded medical equipment tornado? The smart dust tornado?

The Investor's Dilemma is that no previous technology has presented us with the particular set of challenges that this one is presenting us with. And the solution is as old as the hills, depending on your personal risk tolerance and your economic situation, you place your bets and you takes your chances.

Today it is easy to say, with 20-20 hindsight, that ARMHY at \$2

was an easy decision to make. But this is a terribly faulty statement. There were a lot of people unloading at \$2 and glad to be rid of this bag of rot. You might recall some Fool articles calling ARM's management incompetents and crooks.

In conclusion, while many unknowns remain, I think it is a mistake to undervalue ARM's potential based solely on the fact that ARM is behaving like a "nice" gorilla as DirtyDingus dubbed ARM.

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