



Eastman Kodak finds itself at a crossroads

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Wait till next year.

It's a familiar refrain for Bills and Mets fans, and it has become Eastman Kodak Co.'s mantra. Like a struggling sports franchise, the photo and imaging company has spent recent years repeatedly rebuilding.

There were the dark years of 2004-2007, when Kodak, looking to shift its primary focus from film to digital technology, took huge cost-cutting steps that included shedding thousands of workers locally. For a brief time the strategy appeared to be working, with Kodak enjoying three consecutive profitable quarters in 2007.

Then the recession hit. The company has been in the red for 11 of the past 14 quarters while sales keep shrinking alarmingly — from \$14.3 billion in 2005 to \$7.2 billion last year.

And don't even talk about the stock price. Fifteen years ago, shares averaged \$75.45. The stock closed Friday at \$2.77.

For those who would say the company's fate doesn't matter anymore, consider this: Around the globe, the Kodak brand is still the one most closely associated with Rochester; the company is the fourth-

Declines on top, bottom lines

Falling revenue shows the impact that film's decline had on Kodak and how its digital strategy hasn't yet compensated. The company has lost money five of the past six years.



Kodak vs. Apple

Eastman Kodak Co. and investors are waiting anxiously for Oct. 30. That's when a ruling is expected from the U.S. International Trade Commission on a Kodak complaint that Apple Inc.'s iPhone and Research in Motion Ltd.'s BlackBerry use camera technology owned by Kodak.

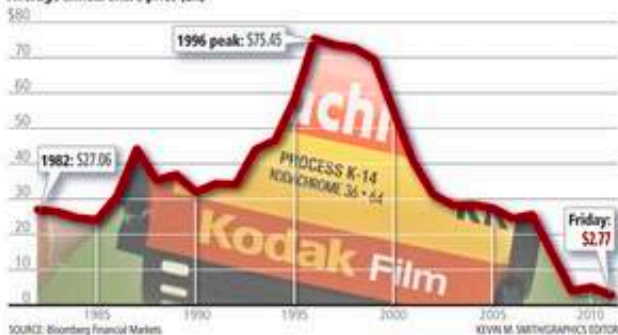
A ruling in Kodak's favor could result in a huge windfall for the company because it would be a strong motivator for Apple and RIM to settle the case.

RBC Capital Markets analyst Mike Abramsky has estimated the value of a favorable ruling at as much as \$1 billion, with Apple and RIM potentially settling for \$450 million to \$550 million each.

The rise and fall of Eastman Kodak stock

Kodak's current stock market value is less than 2 percent of Hewlett-Packard's and 7 percent of Xerox's.

Average annual share price (EK)



what happens next — from today's customers to the estimated 23,000 retirees and retiree spouses in the area who are counting on the company for benefits.

The CEO of one Kodak customer, Hammer Packaging, said his Henrietta company has been investigating alternatives for some time.

largest employer in the region with about 7,000 workers; and Kodak is a major philanthropic presence in the community.

But the 119-year-old company is going through another dark patch as it slogs ahead in what it hopes will be the last year of decline.

"We will complete the transformation of this company to a sustainable and profitable digital company by 2012," CEO Antonio M. Perez declared earlier this year to financial analysts gathered at the NYSE.

There is plenty of evidence that Kodak stands at a crossroads, with one direction leading to a remarkable business turnaround and the other leading to any number of potential scenarios such as bankruptcy, a takeover, or a breakup and sale of assets. The next few months could determine which road is taken.

Wall Street is largely pessimistic about Kodak's prospects, as evidenced by the stock price. But investors and analysts are paying close attention to the company because it's trying to find a buyer for 1,100 of its digital imaging patents, potentially reaping a huge sum that could help cover the expense of building up a set of relatively new business lines on which it could rely for growth.

Concerned that a buyer of the patents might find it cheaper to simply buy the whole company, Kodak earlier this year adopted a shareholder rights plan, commonly known as a "poison pill." The plan would seek to make an unfriendly takeover prohibitive by issuing more shares, driving up the cost of an acquisition.

Meanwhile, Kodak's checking account is getting steadily slimmer. As of the end of June, it had \$958 million in cash and cash equivalents, down 41 percent from the end of 2010.

All of which has plenty of people nervous about

"I don't want to put all our eggs in one basket, given what they're going through," said James Hammer. "Kodak makes good products, don't get me wrong. The quality is good, the service is good. But you never know what's going to happen."

Kodak retiree group EKRA has been counseling retirees on what to do when the company makes more dramatic cuts to its retiree benefits. "It's a matter of when," EKRA President Bob Volpe said.

Light in the tunnel

Kodak for more than 100 years has been an expert on printing. Making film, at the end of the day, is just a kind of printing, putting chemicals on a plastic surface. Now the company is banking on its desktop and commercial inkjet printer lines, its packaging printing business — including all the supplies such as ink that printers need daily — and on workflow software to be the growth businesses that offset the declines in digital camera sales and film.

There are hopeful signs. According to information technology industry research group IDC, Kodak as of the second quarter of this year had close to 3 percent of the worldwide consumer inkjet market, up from about 2 percent a year earlier. Competitors such as Hewlett-Packard Co. and Canon Inc. grew much more slowly over the same period or even experienced slight decline.

Revenue for the four core business lines increased more than 20 percent in the first six months of this year. Consumer inkjet printing, in particular, is growing far faster than the inkjet market overall "because the value proposition is different than what the competition brings," said Chief Financial Officer Antoinette McCorvey.

The four growth businesses started out as part of a list of 11, McCorvey said.

"As a piece of adapting, after the recession started to happen, we started to narrow down," she said. "We said we can't invest in all of these, and we made some choices. ... We chose to try to grow in a place where we have unique capabilities. We think this is the right four and the right number."

Kodak's traditional money tree business, film, continues to be profitable, if shrinking. Motion picture film still has legs, especially as the weak economy has slowed the pace of theaters converting to digital.

"I suspect (film) is going to last for a number of years yet to come," McCorvey said.

Not all Wall Street analysts are down on Kodak. Those who are "really haven't taken the time to understand it," said Mark Kaufman of Rafferty Capital Markets, who pretty much stands alone in rating Kodak shares a "buy."

Kaufman said the analysts bearish about Kodak "also think Apple can do no wrong and that it invented the automobile and the airplane. All they do is moan about Kodak's dying film business and how it's losing money. No one on the Street recognizes the value of their patents and new printers. The Street is focused on earnings (and) that is foolish to do when a company is going through a transformation."

Just the tunnel

In 2003, as Kodak looked to grow its digital business with sizable investments and cut its dividend payout, dissident shareholders floated ideas such as splitting the company into distinct business units or selling off parts.

Those ideas have gained renewed traction.

"It's got to be part of a larger organization," said Gregg T. Abella, co-principal with Investment Partners Group, a New Jersey investment firm. "That's sad, but it's a reality. They took too long to turn it into a digital company and now they're forced to take their intellectual property and monetize it rather than commercialize it

"I don't think they have the capital to commercialize these kinds of technologies on their own, and I don't think they currently have the ability to go and raise more debt or equity on favorable terms. They're out of bullets."

Credit rating giant Moody's Investors Service earlier this year lowered its grade on Kodak long-term debt to Caa1 — a low-quality, high-risk investment. The rationale, according to Moody's, is that profitability is nowhere in sight for the company minus any income from the licensing of intellectual property.

And Fitch Ratings earlier this year reaffirmed its "issuer default rating" for Kodak at CCC, the same as the fiscally troubled nation of Greece.

Meanwhile, the growth areas that Kodak is counting on have hit a speed bump. The company said in July it expected the cluster of businesses as a whole to have sales growth of 30 percent to 40 percent this year, down from the 40-plus percent it had previously predicted.

The paths Kodak has chosen also put it in the way of one of the biggest business gorillas on Earth, Hewlett-Packard. The 310,000 home desktop inkjet printers Kodak shipped in the second quarter represented about one-17th of what the Silicon Valley company shipped.

While Kodak is making some headway in pushing its growth initiatives, those have been overshadowed by the ongoing decline of other businesses, said James Kelleher, an analyst with Argus Research Co., who has a "hold" rating on Kodak stock. Record-high silver prices, for example, have crushed the profit margins of the film business.

"Given that royalty income (from licensing its patents) is the deciding factor between profit and loss, and this outcome is largely out of the company's hands, our confidence is low at this time," Kelleher said.

Turnaround

The history of American business is replete with examples of major corporate comebacks, from Apple Inc. to Tyco International. But there also is a crowded graveyard of companies unable to turn dire situations around, with Pan American World Airways and Polaroid as examples.

Tactical turnarounds can be painful as a company cuts people and operations. Strategic turnarounds, like Kodak's, have the added burden of being "incredibly difficult," said business turnaround expert William K. Snyder, who oversaw the resurrection of chicken processing giant Pilgrim's Pride.

"It's very, very difficult to move a company into a new place. Strategic turnarounds are having to reposition a company in respect to all its stakeholders — its customers, its suppliers. It includes a lot more people and a lot of it isn't under your control."

As for Kodak's years-long turnaround efforts? "We call that 'death by a thousand needles,' a slow, agonizing turnaround," Snyder said. "When we do a turnaround, we try to do one cut and make it final, one giant cut. So you can go back to everybody and say 'we're done.' The morale issue is depressing. It takes a huge toll on your people. At some point there's nothing left to cut."

Though Kodak has talked for years about becoming a digital-first company that milks its traditional film business for as long as it remains profitable, its Film, Photofinishing and Entertainment Group remains nearly as big as its Consumer Digital Imaging Group in terms of sales. And for the first half of this year, the Film Group lost the least amount of money from continuing operations.

"The issue with Kodak is what can they do now, this late in the game?" Snyder said. "What can they possibly do to leapfrog? I guarantee there's something out there, some technology. The question is, do they have the people there that can try to do that leapfrog?"