This 3DAdvisors Report Covers:
✓ **Insider Trading**: Insider Trading Behavior
✓ **Accounting**: Quality of Earnings Issues
✓ **Governance:** Corporate Governance Issues

Accounting and Selling Behavior Imply Growth Issues NCR Corp. (NYSE:NCR)

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NCR Corporation and its subsidiaries provide technology and services that enable businesses to interact, connect, and relate with their customers worldwide. It operates in seven segments: Data Warehousing, Financial Self Service, Retail Store Automation, Customer Services, Systemedia, Payment and Imaging, and Other. The company sells its products and services through direct and indirect sales channels. NCR has operations in the United States, Europe, Middle East, Africa, Japan, and Asia-Pacific. The company was founded in 1884 by John H. Patterson under the name National Cash Register Company and changed its name to NCR Corporation in 1974. NCR Corporation is headquartered in Dayton, Ohio.

Summary of 3DAdvisors Findings for NCR

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- **Accounting:** Just prior to Hurd's departure, non-core items in '04 earnings
- **Accounting:** Reluctance to take impairment charges
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Discussion of 3DAdvisors Findings

Though NCR shares seem to have recovered somewhat from their rather stunning 20% two-day drop in the wake of the sudden exit of CEO **Mark Hurd**, we have observed a variety of insider trading and accounting behaviors prior to and immediately following his departure for the top job at Hewlett Packard that have caused us to zero in on the Company. Some analysts argue that, thanks to the contributions of Hurd during his tenure, the Company is on-track and will deliver both the promised $250 million in cost savings plus continued double-digit revenue growth in the Company's key Teradata (data warehousing) and Customer Services segments, and that Hurd's departure has now been discounted in the price of the stock. The behavior we have observed clearly contradicts such a thesis.

Hurd was welcomed by analysts as a capable cost cutter, and driven by a strategy of combining significantly lowered costs with renewed growth from two of its more promising divisions, the stock has enjoyed significant price appreciation since shortly after his arrival. We are far from convinced, however, that Hurd has left NCR well positioned to continue its momentum. There is evidence that two years of vicious cost-cutting has run out of steam and at the same time seriously damaged employee morale, and that true, sustainable revenue growth still appears elusive, at best.

In a May 2nd Letter to the Editor of *Business Week*, a seven-year NCR veteran contends that "no products were brought to market during Hurd's tenure that led to real growth in NCR's revenue. His success resulted from drastic cost-cutting…it remains to be seen whether that alone will contribute to long-term profitability and any new growth." Though we rarely put much weight on the material found on internet message boards, we note that in the case of NCR the postings from disgruntled employees seem particularly vitriolic toward the Company and Hurd as a result of aggressive cost reduction efforts.

We bring these issues up only because they provide some interesting context for the insider trading behavior we have observed and originally reported in the *Insider Research Bulletin* published on 05/21/05. Additional research reveals a Company whose executives seem to have relied heavily on managing earnings beginning with the period following Hurd's entrance; an absence of strategy to deal with flat business segments; and a recent proclivity (during the Hurd tenure) to invest huge amounts of cash in stock repurchases that far exceed expenditures for capital spending or product development. These items, coupled with the fact that insiders have succeeded in monetizing the majority of their long term options positions, present a picture that would suggest that the timing of Hurd's departure may have had as much to do with worsening prospects at NCR as it had with any upside potential for him at Hewlett Packard.

Accounting: Creative reserve creation and opportune reversals

Ever since Hurd's October, 2003 appointment as CEO, NCR has displayed a troubling tendency to establish and release reserves in the absence of solid facts to support the actions. This is particularly true with respect to the timing of such actions among and between fiscal periods. Take, for instance, the $8 million (after tax: $0.043 per share) in Other Income in 2004 recorded as a result of reversing a reserve "for exit of certain countries in the Middle East and Africa Region…however, due to a strategy realignment, the Company now believes it can profitably market an attractive range of products to the countries…" This previously established reserve, ostensibly recorded due to an inability to market products in these countries, followed not long afterward by its reversal due to a new found belief that products can now be marketed profitably, presents a good case-in-point.

But there's much more here. At 12/31/2004, NCR had carried a $4 million reserve "in anticipation of non-payment of a non-trade receivable" with one of its Japanese affiliates. The period in which this reserve was established has not been disclosed. In Q4, 2004, however, the Company received payment of the $4 million and reversed the reserve, which added $0.022 per share to earnings in the quarter.

As of 12/31/2004, NCR had a $1 million reserve "for an environmental liability related to a former manufacturing facility." In February of 2005, after the Company's Q4 release (for the quarter ended 12/31/2004), NCR disclosed that "additional developments caused us to increase our reserve (related to this facility) by $2 million. Instead of recording the adjustment to the then-current Q1 period, "the adjustment was made to NCR's 2004 financial statements to reflect this change." So, the Company, no doubt using the safe harbor of immateriality, moved the increase to the reserve back into the previous year in lieu of taking the hit in the current quarter.

Another interesting reversal occurred in Q1, 2005 when the Company included "the benefit of a $6.5 million reduction of accruals made in previous periods for purchased goods and services. The reversal resulted in the reduction of operating expenses of $2.7 million and the reduction of cost of products and services of $3.8 million." The Company goes on to explain that "the over accrual was primarily due to the incorrect acknowledgement of goods and services received…", and that "…the Company has taken action, such as increased user training and enhanced monitoring controls, to mitigate the potential for replicating this matter." For us, believing that this reduction in accruals, made in previous periods, by incorrect acknowledgement of goods and services was a result of a simple error is hard to swallow. Someone had to make specific entries to record those incorrect accruals. In our view, NCR's explanation is, at best, unfulfilling, and at worst, a continuation of a behavioral pattern of creatively creating and opportunistically reversing reserves to obviously manage earnings.

Accounting: Just prior to Hurd's departure, non-core items in '04 earnings

Including the reserve reversals mentioned above, NCR received plenty of juice from non-core sources in '04: $17 million in Real Estate gains, $3 million from an acquisition breakup fee; $4 million for the recovery of the non-trade receivable that had been fully reserved for; $9 million from the release of the reserve established the NCR's anticipated exit of countries in the Middle East and Africa region. These totaled $33 million, or 13% of pre-tax income. We note the timing of the inclusion of these non-core items, including reserve reversals, just prior to Hurd's announced departure.

Similar effects came into play in Q1 of 2005 as reversals in accruals (described above) amounted to 16% of the Company's pre-tax net.

Accounting: Reluctance to take impairment charges

We found the $10 million write-down, in Q1 of 2005, of NCR's 26% ownership in a German company to be very interesting. NCR discloses that, on April 5th, the "German company disclosed that it had been contacted by a third party who offered to purchase all of the outstanding shares. In the same disclosure, the German company also announced its 2004 operating results and its 2005 projections. These events caused NCR "to reassess our ability to recover the carrying amount of our equity investment…"

It would seem that NCR, with a 26% position in the company, which it accounted for under the Equity Method, may have been delaying the write down of this investment, and more likely than not, NCR was aware that the fair market value of the investment was sinking below its book value but hesitated to take the write down until it had no other choice. Taken in context with the other behaviors we have observed, we are not surprised.

This reminded us of the large $348 million Goodwill impairment charge taken by NCR upon the adoption of SFAS 142 which was certainly one of the larger initial 142 write downs (as a percentage of the total Goodwill number) that we've seen. It seems that, if certain asset values on NCR's books are, in fact, deteriorating, investors will be the last to know, and only after deterioration has gotten to the point where the Company is forced to disclose the impairment.

<u>Insider Trading: Big selling and holdings reductions by key operating executives</u>

Had the insiders at NCR simply begun selling in the wake of Hurd's departure, it would be easy to call the activity news-related. However, eleven insiders at the company have sold a total of 872,539 shares beginning on February 2nd, well before Hurd's sudden late-April defection (see Figure 1 below) and May 18th. The fact that they began selling well in advance of his leaving (580,057 shares were sold in this period prior to his announced departure), coupled with the fact that so many of them are clearing out the majority of their long-held options (and common) positions, helps confirm our notion that Hurd and the administration he left behind may have squeezed just about all they could out of their optimization strategy and now, faced with the prospect of engineering organic top-line growth, additional upside seems limited. In other words, these insiders may not be leaving the ship because it's sinking, they may, instead, be getting off because it can't pick up speed.

Figure 1. NCR Daily Closing Price, May 3, 2004 through May 31, 2005. Blue diamond is the date that Hurd's departure was announced; blue shaded area is where 11 insiders sold 872,539 shares. Sources: Reuters, NCR press release, and SEC Filings.

Not only have insiders picked up their selling volume this year but, more importantly, they have become much more aggressive with their options activity, as many have cleared out of the vast majority of their long-vested options which had been held for a number of years. The selling has led to some of the largest position reductions that we have ever seen here, including CFO **Peter Bocian** who sold 65% of his holdings, and Chairman **Lars Nyberg** (53) who distributed all of his common stock and now only holds 7,700 vested options. Two other key insiders that recorded substantial reductions in their actionable holdings (common stock plus exercisable options) were **Michael Koehler** (57% reduction) and **Gerald Gagliardi** (50% reduction). What makes their behavior so important is that they are the heads of the two key divisions expected to bring in the growth for NCR's future: Teradata and Worldwide Customer Solutions, respectively.

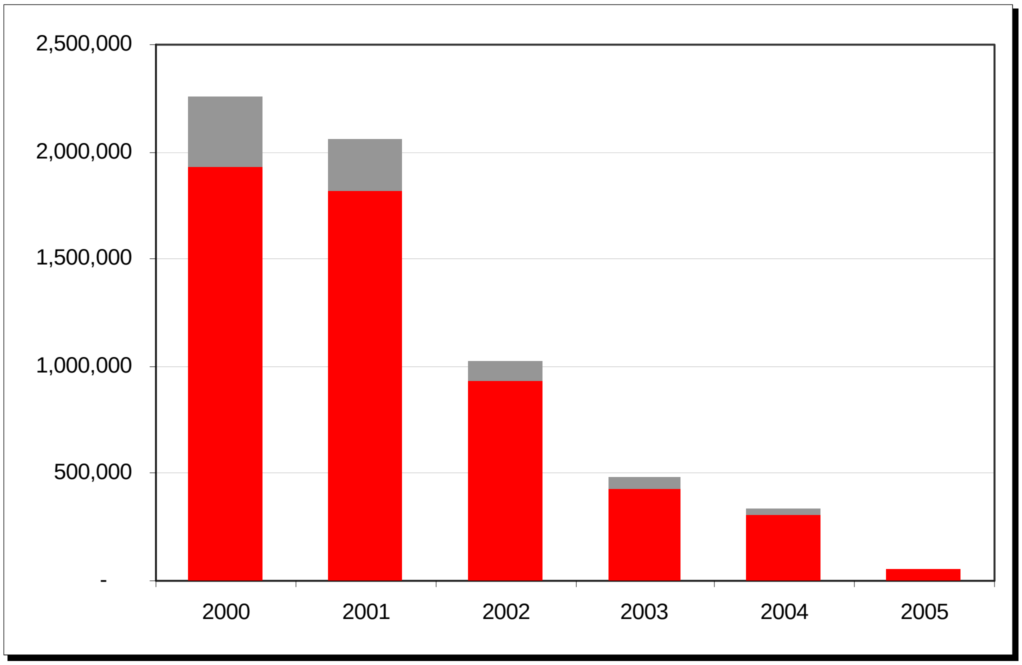
Table 1. Holdings Reductions by NCR Named Executives. Source: NCR SEC Filings.

		Holdings as of:				Reduction
		01/01/02	**01/01/03**	**01/01/04**	**05/15/05**	**Since '04**
Ringler	CEO/Dir	**--**	**--**	8,554	32,210	N/A
Gagliardi	SVP	173,332	361,072	287,098	143,254	**50.1%**
Hoak	SVP, GC	--	--	376,684	250,704	**33.4%**
Bocian	SVP, CFO			70,777	24,827	**64.9%**
Koehler	SVP	--	--	229,468	99,309	**56.7%**
Taylor	SVP	--	420,744	274,580	190,745	**30.5%**
Nyberg	CB	5,639,488	7,321,342	39,776	7,777	**80.4%**

The aggressive behavior exhibited by these insiders is quite revealing when one takes into account the declining number of stock options granted and restricted stock awarded over the past few years. As Figure 2 below indicates, incentive awards for the Company's named executives are a fraction of what they had been as recently as 2003. What's more, NCR grants options with a three-year vesting schedule, which means that the one million options granted in 2002 have vested in full. There will be very few new options vesting in the upcoming twelve months to replenish what they've sold since February. We will be closely monitoring this situation to see if NCR's management continues to cash out of their positions.

- **Peter Bocian (50)** – Senior V.P., CFO. Though Bocian has been with NCR since 1983, it wasn't until late 2003, upon the assumption of his interim CFO duties, when he would first register as a Section 16 insider. Since then, he's sold on four occasions, gradually increasing his volume into the issue's strength. His selling has picked up significantly this year as he cleared out of 40,000 shares in February at $34 prior to Hurd's departure, and then later sold 21,000 shares on May 16th at $37 into the rally off the May lows. The May selling included the most aggressive option exercising we've seen from him, as he exercised four series of non-expiring options (expiration dates: 1/09, 1/12 @ $19.88, 1/12 @ $20.59, 2/13), two series of which were held by his wife. In all, the year-to-date sales **dropped his (and his wife's) holdings by 65%**.

Figure 2. Stock Option (Red) and Restricted Stock (Gray) Grants to Named Executives. Source: NCR SEC Filings.



- **Michael Koehler (52)** – Senior V.P., Teradata Data Warehousing Division. Though his incentive equity awards have been on the decline year-over-year (he received 70% fewer options in 2005 than he had in 2002), Koehler has shown little restraint with his selling since he initially filed as a Section 16 insider back in March 2003. His combined 2004 and 2005 sales totaling 181,626 shares have **trimmed his holdings by 57%**. Most recently he cleared out his January 2010 options on February 4th, selling all 32,000 shares at $35.84, and then later cleared out his January 2011 options and exercised all of the vested options remaining in his March 2013 series in order to sell another 34,000 shares at lower prices ($33.70). The fact is not lost on us that Koehler heads up NCR's key Teradata division, which is expected to show double digit revenue growth in 2005.

Options/Restricted Stock Granted to Michael Koehler:

2001	2002	2003	2004	2005
24,000	18,000	76,000	31,500	19,125

- **Gerald Gagliardi (57)** – Senior V.P., Worldwide Customer Services Division. Gagliardi joined NCR in 2001 after serving as a consultant at E.M. Warburg Pincus. It wasn't until early 2004 that he executed his first sales, and by year-end, had distributed 90,664 shares. His selling pace has intensified in 2005, as he has already sold 126,666 shares between February 2nd and May 18th at an average price of $37. The selling has **wiped out half of his holdings since the 2004 Proxy**, which is significant because Gagliardi was granted 344,000 options between 2001 and 2003, but only 43,046 options since. At this current selling pace, he will monetize a majority of his holdings by year-end, and this from the head of the second key division expected to generate double digit revenue growth in 2005.

Options/Restricted Stock Granted to Gerald Gagliardi:

2001	2002	2003	2004	2005
220,000	80,000	76,000	40,400	13,501

- **Keith Taylor (54)** – Senior V.P., Financial Solutions Division. Since February, there has been a noticeable change in Taylor's trading behavior. Last year, he executed two similar sales in June and November, selling 23,000 shares at $24 and $28. In both instances, he never exercised more than three option series. In February 2005 he exercised seven different series (and cleared out five of them) with expiration dates ranging between January 2006 and February 2010. He sold the underlying 47,000 shares at roughly $38, marking his largest sale since he became a Section 16 filer back in 1998. But the activity didn't end there, as on May 10th he cleared out his February 2010 options, selling 45,482 of the 50,482 shares he acquired at lower prices ($35) than his February activity. Not only did he accept a lower price for his stock, but has now **sold 33% of his holdings** on the year. Don't look for Taylor's holdings to be significantly bolstered by future options vesting as his grants have been on the decline since 2002.

- **Jonathan Hoak (55)** – Senior V.P., General Counsel, Secretary. Hoak has been NCR's lead counsel since coming over from AT&T in 1993. His selling was never really notable until last year, when his volume picked up into the higher prices. The pattern has extended into 2005, as he has sold nearly as many shares since February as he had over the past seven years. On February 3rd Hoak cleared out his February 2008 options and sold the 50,000 shares at $35. A month later, shortly before Hurd's departure, he sold 35,888 shares at $38 after he cleared out his January 2007 option series. Then, as the issue was struggling to rebound after Hurd's defection, Hoak exercised his January 2009 option series and sold another 33,000 shares at $35. The only other time he's executed this many transactions in a year was back in 2001, as the issue slid from $25 to $18, and even then, his selling wasn't within such a short period. That he was willing to **part with a third of his holdings** after being a net accumulator over the years provides an additional clue that uncertainty seems rather prevalent among the insider ranks.

One additional note: Jonathan Hoak and Keith Taylor had held NCR shares in their 401-K's but transferred their investments out of Company stock and into alternative investments late last year. The amounts transferred were not large enough to be considered part of diversification strategies, especially in light of the subsequent aggressive selling displayed by each.

<u>Governance: Huge increase in share repurchases best use of cash?</u>

There are times when it feels almost patronizing when certain companies attempt to pass their share repurchase activity off as the best use of cash in the interest of enhancing shareholder value. We buy that argument when a company buys back shares at low prices. When companies spend huge amounts of cash, however, to buy back shares on the open market at all-time highs, while at the same time insiders are selling out big pieces of their positions, we have a problem with the implied motives of the management involved.

We feel just this way about NCR's repurchase activity, which absolutely dwarfs the Company's investment in its own businesses. During 2004, NCR burned through $428 million to repurchasing shares. In Q1 of '05, another $120 million was spent. During these periods, the Company invested just $77 million and $2 million, respectively, for Property, Plant and Equipment expenditures.

This also brings to mind the Letter to the Editor in *Business Week* that we mentioned above, where the author maintains that few if any new products of consequence were launched during Hurd's tenure that had any significant impact on the Company's growth.

Accounting: Miscellaneous noteworthy items

- **Dollar "tailwinds" have shifted to "headwinds":** Given the sophistication of our constituency, we do not need to elaborate on the recent strength shown by the dollar, especially against the Euro. Nor is it necessary for us to get into the events that may have caused the recent rally in the Greenback. What we do want to highlight, however, is the dependency shown by NCR, in recent periods, on positive currency fluctuations.

  In 2004, as the dollar weakened relentlessly against the Euro, and other currencies, NCR disclosed that over half of its 7% revenue growth (or 4%) was related to the weak dollar situation. Currency tailwinds played no less a role in Q1 as again 50% of NCR's 4% revenue growth (or 2%) came from currency gains. It will be interesting to see what the impact will be in coming periods, especially if the dollar continues to strengthen, especially against the Euro.

- **Pension plans present persistent problems:** Although the Company has closed its defined benefit plans to new participants, it's no secret that NCR's legacy pension burden has the tendency to yank earnings around from year to year, and this is a pattern that shows no signs of abating as pension costs are on track to exceed $100 million in 2005. The situation is pervasive enough that top management incentive compensation is calculated on a formula that eliminates the pension effects on earnings. In addition, NCR plans to contribute $124 million to its international pension plan, plus an additional $8 million to its executive pension plans during 2005.

- **A very large deferred tax asset valuation allowance:** NCR carries a $585 million Valuation Allowance against its Deferred Tax Assets which total $1.3 billion. The bulk of these Deferred Tax Assets relate to tax loss and credit carry forwards. The existence of this large Valuation Allowance offers a fairly bleak outlook for future profit prospects it would seem, in spite of the Company's optimistic projections.

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