

Intelligent Investing

Chip Renaissance Brings Higher Valuations

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A big new tech cycle is in full swing, fueled by secular adoption of mobile Internet, cloud computing and e-commerce, along with modernization of the IT installed base, innovative industrial applications, rising affluence and an increased proclivity towards electronics-based goods and services. This confluence of factors has led to sold-out chip production, rising mix ASPs, new record revenues, margins and profits, along with a move to fundamentally reappraise valuations across the chip and equipment spectrum.

As in the four years leading to 1992, these companies have reengineered with higher value products that are allowing customers to field attractive new offerings across multiple end markets. This is the principle reason earnings reports have once again materially exceeded Street views. The global economic rebound has also played a part in the electronics recovery, but this is a subsidiary factor, not the prime mover some think it is and thus not a source of concern should the broad macroeconomic trend decelerate as many believe.

Rather than a mere derivative of global cyclical rebound, industrial production and exports that are running well ahead of nearly everyone's forecasts, the high-tech renaissance is the facilitator in this second round of global integrated growth (*GIG*), the first of which ran from late-2002 through mid-2007. The first *GIG* round was predicated upon basic infrastructure to facilitate widespread trade and commerce among nations that had remained largely separate and distinct in the post-World War II period. In particular, China pursued Maoist Marxism-Leninism while near-as-populated India's third way also eschewed capitalist exchange, preferring barter deals to unfettered commerce. The Soviet Union and its Eastern European Warsaw Pact satellites opened up earlier but have only come into their own this past decade.

For the nearly five-year, synchronized global expansion that ended with mid-2007's financial meltdown, high tech was basically low tech, focused on cost-sensitive, high-unit-growth consumer markets, with high-value enterprise computing and communications largely working off the 1990s excesses. Chip companies saw reduced-mix ASPs, modest revenue growth and lower margins, repeatedly falling short of expectation after the first burst off the fall 2002 bottom ran out of steam, the sector falling into brief inventory-driven swings. Investors rightly took semis off the growth list, moved them to near pure cyclicals, truncated multiples and looked to faster-moving

targets. The sector-wide meltdown of 2008 entrenched the view that semis were mere cyclical.

Yet, higher speed broadband and mobile Internet led to a series of new high-tech goods and services accompanied by reengineered industrial products and processes, many of which rely on Internet connectivity for premium selling attributes. This innovation cycle, as some term it, is filled with new products literally creating their own demand, iPhone and iPad only the more widely publicized instances. Similarly, the startling success of American, German and Japanese capital goods exports has its own electronics-based story to tell. Certainly major Chinese investments and less ambitious Western fiscal programs played a role, but the precipitating variable has been always on, quicker Internet connectivity producing personal and corporate productivity what nearly anyone imagined. This latest innovation and resulting productivity boom is what's allowing business the world over to quickly rebound from the U.S. capital markets crisis of just two years ago, shrug off Europe's pale imitation, ignore the global debt overhang and the multitude of other presumed negatives that were to have precipitated the new global depression, decoupling, end of capitalism, double-dip and the like.

Instead, as upped airliner build rates at Boeing and Airbus, much improved freight traffic at UPS, FedEx and Union Pacific, rising airline load factors and profits, not to speak of booming SmartPhone, Pad, server and notebook PC sales attest, the global economy is positively vibrant. As so often is the case, it's just structurally altered from the last cycle, with commodities and raw materials no longer the driving force after decades of underinvestment in new supplies and unexpected new demand in emerging regions. This time, old infrastructure is displaced by high tech's broad reach that ups output while holding labor and other input prices in check, keeping inflation at bay and interest rates lower than they'd otherwise be. In short, something of a 1990s redux.

As investors come out of their shells and realize the world's not only not ending but that expansive opportunity is all around, they will look for the new gatekeepers, those fielding products that control the present state of affairs, with special emphasis on stocks few really know yet. Each month new sales of smartphones and Pads add tens of millions of new, high-speed Internet connections, with each one of these thin-clients near totally open to the cloud as they interact with social networking sites, user communities and maps. Since these devices don't have the microprocessing or memory buffer of traditional desktops, notebooks or even netbooks, the minimal security they afford materially ups the requirement for clean, reliable and fast connectivity out in the network. These factors play right into NetLogic's wheelhouse as it launches new product families integrating the special capabilities and intellectual property the past two years' major acquisitions have brought to bear.

Several weeks after announcing ultrafast chips to up data center performance while reducing power consumption and, in a major security breakthrough, real-time Internet packet analysis and processing operating at 40 gigabits per second (as in, super quick), NetLogic this week came out with another blockbuster. Its latest is a family of multicore chips, scalable to 128 processors per chipset with 160 or more processing engines operating at 160 gigabits per second, capable of operating at 240 million

packets-per-second. These are designed to manage and secure next generation networks from today's installed based right through 4G-LTE wireless now shifting from the planning stage to full-implementation.

As bits of data stream back and forth from proliferating user devices such as smartphones, Pads, notebooks, netbooks, dashboards and myriad other interfaces, this family of intelligent, interactive processors will find its way throughout the increasingly labyrinthine communications infrastructure. Every 4G-LTE base station is a target of the lower-power-consuming, lower-price-point versions, not just the network core that is a complex rich market all its own for higher-end variants.

Up until now still something of a startup as the big acquisitions are digested, the synergistic new products fielded and earnings continue to reflect performance-based workouts to shareholders of the acquired entities, the holistic NetLogic should begin to usher forth in coming periods. We will be watching tonight's earnings release for the telltales.

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