

Intelligent Investing

Chip Stock Glory Days

Rick Whittington, 03.24.10, 1:20 PM ET

Skepticism still reigns in semiconductors, while inventory and new orders belie the underlying strength of the group.



It's been awhile but chip stocks are returning to their past incarnations as the darlings of tech. Defying an ever hesitant investment community, semiconductor fundamentals are shaping up like the 1990s glory years. DRAM prices have continued to climb during the recent seasonal lull in consumer PC demand with major OEMs contracting for increased quantities at higher prices and willing to pay up front for access to forthcoming supplies.

This signifies rising build rates for enterprise servers and corporate PCs, heralding the second-half 2010 DRAM shortage of some forecasters. Tertiary supplier Integrated Silicon Solutions just upped quarterly revenue guidance 10% and gross margin guidance 20% from previous levels.

Meanwhile, NAND flash prices have held steady the past several months during what is easily this market's slowest time of the year tied to typically weak post-holiday consumer electronics activity and a big three NAND supplier, Toshiba, is pushing forth with plans for a new production facility. Micron Technology, which derives about two-thirds of its revenues from DRAM and one-third from NAND, is nearly certain to knock the cover off the ball with next week's earnings report, while setting the stage for subsequent big upsides ahead. Its stock is just getting back over \$10; Micron's going to earn about \$2 per share in calendar 2010, with the following year probably higher. You figure where this baby's headed.

Optical component supplier Finisar just completed an oversubscribed secondary offering to pay off debt and was able to up both the number of shares and their price as observers warm to the notion of a multiyear broadband Internet infrastructure build out and modernization. The stock just eclipsed a two-year high, but is still about one-third of their early 2006 high, back when network spending was a fraction of what the next several years' potential brings to mind. Along with the similarly heavily restructured Oclaro, the prospect of materially higher margins on catapulting revenues is turning this into one of the new tech darlings.

These remain undercapitalized, relatively uncovered companies following a lost decade after the 2000 to 2001 optical networking crash. There's a long way to go for these to represent earnings machines and each is just now moving out of red ink with gross margins just to or above 30%, but capacity has been rationalized and competitors absorbed. This week's San Diego optical show is pivotal. Buy.

This week NetLogic Microsystems split two-for-one, pushing the share count from miniscule to small, and the stock responded with another in a succession of all-time highs these past months as investors reckon the potential of three, four or five years of rising capital outlays throughout the wireless and wire line grid. Its more than just upping bandwidth and turning up transmission speeds to accommodate smart phones and booming rich media, important needs in their own right, but which pale next to network redundancy and security considerations. NetLogic's family of communications chips addresses many of these issues and they are unique in several niches, meaning stable chip pricing and rising profit margins. Just how much the company will earn this cycle remains to be seen as today's NetLogic has been cobbled together from several acquisitions and the analysts are still using pro forma, non-GAAP accounting.

Meanwhile, green tech gurus First Solar and SunPower are beset with reduced subsidies to customers that had built frenetically the past several years. Flattening profit margins, missed earnings and dour outlooks speak to the investment risks in industries with heavy government involvement. Avant garde VCs and private equity firms may have flocked to this arena when oil was going through the roof a few years back and political fervor was a peak proportion but financial returns have proved subpar even with oil at six times its decade-ago price. Were these DRAM makers, with continual manufacturing cost reductions and rising unit demand, the profits would be today be legion, much as Micron's earnings escalated during the 1990s--but they are not.

The good news from the poor green tech investments made by the Sand Hill Road gurus is the paucity of new issues in the deal pipeline. This means classic tech will acquire greater scarcity value in the year or two ahead, the established companies the big beneficiaries of the demand that lies ahead. Balance sheets are generally clean, so aside from a few chipmakers that still have to pay off convertible debt, only a few such as Micron have unwieldy debt burdens that will require large offerings. Several moderately indebted semiconductor companies such as Linear Technology, Analog Devices, Altera and Xilinx have such high profit margins, low capital requirements and hefty cash flow, they might well choose to not pay it off through dilution. Intel, which has several billion dollars in debt but cash and short-term investments better than six times that sum, has seen its stock creep steadily higher in recent weeks in front of what should be a better than expected first quarter report. If so, the recent upward bolt in semiconductor shares generally will be validated.

If there's a conundrum for the chip investor, it's the recent weakness in chip equipment shares. Followed by a different analyst enclave that often seems woefully out of touch with industry events, semiconductor equipment revenues always amplify by 50% to as much as 100% the growth rates of their customers, the chipmakers, during upturns. Thus, taking the current consensus of about 20% semiconductor revenue growth in 2010 and 10%-plus for 2011, equipment revenues should expand 30% to 40% this year and a further 15% to 20% next. Yet, equipment companies are already roundly discussing growth rates in 2010 of as much as 100% for key items, creating a massive disconnect from what their customers. Herein lies the reason chip equipment stocks have lagged, namely the fear that recent equipment vibrancy is running ahead of the customers real needs.

The other way to view this, of course, is the prospect the chip companies are fudging their forthcoming revenues and will grow far faster this year than they've yet let on, what's in consensus outlooks seriously understates. Instead of 20%, even 25% to 30% revenue gains this year, the average chip company will put 40% or more on the top line, producing one of the

bigger annual gains ever. Much of that momentum would carry over into 2011. Discretionary spending just cannot rise quickly enough to prevent profit margins from going through the roof, with the new industry highs predicted last summer a bold new reality. Rising investor confidence and reasonably low interest rates will combine with the realization that earnings estimates are way too low to spark a steady chip rally right through the traditionally slow May through July time frame. Such occurred in 1993 and 2003, with a repeat close at hand. So when the fast monkeys and short-term traders tell you to sell in May and go away, chuckle and stand fast. You are holding a pat hand.

<http://www.forbes.com/2010/03/24/micron-finisar-oclaro-intelligent-investing-semiconductor.html>
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