

## *TREADING WATER THIS SUMMER*

The market's typical summer doldrums may not end in August or September this year, but rather continue on through the election in November, as we wait to see what happens with Iraq's new government, the price of oil, interest rates, and our presidency. All of these annoying question marks have suppressed the market, keeping stock prices low even while earnings keep improving.

The good news/bad news is a sideways to down market (bad) leading to lower and lower P/Es (good) as the earnings go up. Barring one or more of these issues evolving into something really horrible, a very healthy and undervalued market could emerge.

### **Random thoughts on specific stocks and industry sectors:**

**Amgen** is my one new strong buy recommendation on this new list. You can read my reasons in the Stock by Stock Comments to follow.

**Healthcare:** I have more healthcare stocks on my list than any other sector. One reason for this is that this group is still undervalued, not having benefited from the slump in technology stocks as it has in the past. Also it is considered a defensive place to be in an uncertain market, as healthcare continues to be in demand regardless of the economy or geopolitical chaos. Being overweight healthcare now would not be a bad thing.

**Lennar:** Even though rising interest rates are bound to impact homebuilders negatively, Lennar has a long and consistent record of growing revenues and earnings, making beneficial acquisitions, and diversifying into demographically and geographically favorable markets. They have been increasing their presence in areas, such as Jacksonville, Florida, where retirement home building is focused. That said, investors will probably not drive up the stock price in the intermediate-term future. It's a fine stock to hold, but it is also a candidate for selling if you need the money for something you think will be more profitable.

**Oil and Energy Stocks** – Energy stock prices really haven't gone up as much as all the complaining about the high price of oil might have suggested, probably because most investors think the price of oil cannot stay as high as \$40. I think enough big-picture changes have occurred to keep the price of oil higher for a long time: permanent uncertainty about supply from OPEC and the Middle East in general; increasing demand for energy that will not abate; and unavoidable depletion of reserves worldwide, to name a few. (See Nabors comments.)

### **GROWTH STOCK RECOMMENDATION LIST**

As always, the companies on my growth recommendation list are quality stocks with sound fundamentals, and they meet my criteria for growth at a reasonable price (GARP). Their growth outlook is more robust than that of the S&P 500; they are lead by topnotch management; debt is reasonable; and they are not

overpriced, as measured by ratios of price to earnings, sales, and future earnings growth.

The following comments update information about and my views of the stocks on my list:

## **TECHNOLOGY**

***Flextronics (FLEX \$16)*** – In the company’s mid-quarter conference call (6/3/04) the CEO reaffirmed increased sales guidance, noting again that the approximately \$2 billion in potential revenues from the Nortel deal will be in addition to that guidance, and adding that second half 2004 may be stronger than estimates give it credit for. Company has reported stronger than expected earnings the last two quarters and record 4Q (March) revenues of \$3.8 billion. The electronic contract manufacturer makes everything from cell phones to x-box video game machines. Intrinsic values for the company are as diverse as its products, ranging from \$13 by Morningstar (typically very conservative) and \$30 by S&P, which rates the stock a buy and has a positive long-term outlook for the industry and Flextronics’ future earnings and revenues.

***L-3 Communications (LLL \$65)*** – L-3 provides secure Intelligence, Surveillance and Reconnaissance (ISR) systems, simulation and training, and other defense products to the U.S. Department of Defense, domestic and foreign government agencies, aerospace and defense contractors, and commercial enterprises. In my last update I mentioned that Barron’s featured L-3 in an article “Preparing for the Long Haul – Every portfolio needs a few gems that can really deliver over 10 years or longer”. They were again highlighted in Barron’s in May, having ranked third in the sixth annual “Barron’s 500” list of financially strong companies that have performed for investors and should do well over the next year. In May they were chosen by the Transportation Security Administration to provide an explosives detection system for rail passenger baggage screening, received a contract with Lockheed Martin to develop a crash survival memory unit for the F-35 Joint Strike Fighter aircrafts, and they acquired Beamhit, which makes laser marksmanship training systems. The stock is at a 52-week high and is above the fair value estimates of both Morningstar and the S&P. I would look for a lower entry point.

***UTStarcom (UTSI \$30)*** – The stock price of this telecommunication equipment company jumped recently because it was added to the S&P 400 Mid-Cap Index, forcing mutual funds that mirror that index to buy shares. While growth in the company’s sales in China has slowed along with that country’s economy, and more competitors for UTSI’s wireless Personal Access System (PAS) have emerged in China and India, there is still plenty of growth potential in both countries. India’s wireless subscriber base is estimated to increase to more than 100 million from the current 33 million in the next two years. First quarter sales of PAS handsets set a record at 9.6 million. At \$60 average selling price, that indicates revenues of approximately \$575 million; company and Reuters estimate well over \$600 million in Q2 revenues. The company has recently signed new or

extended contracts with Softbank BB, Japan's leading broadband service provider, Versatel Telecom International, a telecommunications service provider in the Netherlands, Belgium, and Germany, and with Tiscali, for its Pan European rollout of multiservice broadband networks. The stock is not expensive, selling at only 17 times 2004 earnings estimates (\$1.85); and estimates for 2005 (\$2.34) indicate 26%+ growth.

**Comcast (CMCSK \$28)** – Comcast is the largest cable operator by subscriber and revenue. They have been upgrading the AT&T Broadband cable network they bought in 2002—53,000 miles in 2003—and rebuilding their own cable system to accommodate the roll out of more advanced services. In the past month they have announced that: 1) telephone service will be offered to half (20 million) of their cable customers using Voice over Internet Protocol (VoIP) by the end of 2005; 2) TiVo-like functions will be added to their set-top boxes by year end; and 3) Games on Demand, a video game service, will be available on their web site for \$14.95 per month. The company just reported its second quarter in a row with positive earnings per share—the first time in several years. But the balance sheet is strong. S&P expects the company to generate more than \$2 billion in free cash flow in 2004 and maintains their \$39 price target. Dropping their bid for Disney, refusing to pay more than they felt reasonable, is another positive.

## **HEALTH CARE**

**Amgen (AMGN \$55)** – Amgen, the largest biotech firm, conducts research in cellular and molecular biology. Major products include: Epogen (red blood cell stimulation in bone marrow – revenue of \$2.4 billion in 2003), Neupogen (white blood cell stimulation - \$1.3 billion), Enbrel (psoriasis - \$1.3 billion), Aranesp (anemia - \$1.5 billion), Sensipar (hyperparathyroidism – FDA approved in March 2004); they also have five compounds from the recent acquisition of Tularik which are in development for treatment of diabetes, obesity, inflammation, and cancer. One of these is “T67”, which is in Phase III trials as a liver cancer treatment. Another promising new product, AMG 167, for the treatment of osteoporosis, is scheduled for Phase III trials later this year. Based on their projection for earnings to grow 20% annually through 2007, and their perception that Amgen's pipeline is underappreciated, S&P has a 12-month target price of \$75. I believe the current price, which is near a one-year low, offers a good opportunity to own this stock at a reasonable price with little downside risk.

**Biogen IDEC (BIIB \$59)** – The stock price is as high as it's been in two years and is approaching S&P's \$68 target. The recent merger with IDEC has created a biopharmaceutical company with the expertise and infrastructure to research and develop cancer-fighting drugs and auto-immune therapies. Rituxan, the firm's cancer drug for non-Hodgkin's lymphoma, had sales of \$1.36 billion in 2003, and could reach \$3 billion by the end of the decade. Rituxan is also in Phase III trials for the treatment of rheumatoid arthritis and leukemia. Sales of Avonex, for the treatment of relapsing multiple sclerosis, were \$1.17 billion in 2003. Antegren is being codeveloped with Elan Corp. and is in Phase III trials for

treatment of both multiple sclerosis and Crohn's disease. The last two quarterly earnings were negative due to the merger, but earnings for 2004 and 2005 are projected to be \$1.43 and \$1.75 respectively.

**Cardinal Health (CAH \$68)** - This diverse health care company operates in four segments of the healthcare industry. Pharmaceutical supply and distribution, by far its largest business line, is also a low margin operation, but one that offers cross-selling opportunities for its other businesses: medical and surgical products and services, automation and information services, and pharmaceutical technologies and services (PTS). Cardinal Health has been aggressively adding to this high-growth manufacturing and specialty drug development segment through acquisitions. The most recent acquisition, Alaris Medical Systems, develops and manufactures intravenous medication safety systems and other hospital patient products. The company recently came under investigation by the SEC for their accounting of a \$22 million settlement received from vitamin makers who overcharged Cardinal Health. This investigation has negatively impacted the stock price. Long-term risk for this company is low, and the industry should continue to benefit from demographics for some time. S&P has a 12-month price target of \$75.

**Pfizer (PFE \$35)** – S&P summed up the case for owning Pfizer this way: “The company’s drug portfolio is unmatched in terms of breadth and depth throughout the global pharmaceutical market. The diverse line spans medicines to treat major conditions such as cancer, epilepsy, depression and high blood pressure. About 14 PFE drugs are the leaders in their respective therapeutic markets, eight are among the world’s top selling products, and 10 generate sales exceeding \$1 billion a year. The company’s broad range of drugs reduces its dependence on any single product.” Pfizer’s cholesterol-lowering drug Lipitor, with annual sales exceeding \$9 billion, also dramatically reduces the risk of heart attack and stroke in diabetes patients, according to results made public at the annual meeting of the American Diabetes Association. Other drugs with \$1 billion or more in annual sales include: Norvasc (antihypertensive), Zithromax (antibiotic), Celebres (arthritis pain), Viagra (everybody knows what for), Zyrtec (antihistamine) Diflucan (antifungal), Zoloft (antidepressant), and Neurontin (anti-convulsant). Standard & Poor’s price target is \$43.

**Teva Pharmaceutical (TEVA \$66)** – Teva is the largest supplier of generic drugs, makes bulk pharmaceutical chemicals, and has a successful proprietary drug, Copaxone, which is an injectable treatment for multiple sclerosis. They recently acquired Sicor, maker of finished dosage injectable products. Teva is one of the most profitable firms in the generic sector, partially due to how successful management is at “infringing” on impending patent expirations. Teva often produces the first generic version of a branded drug, negotiating deals to share revenues from the generic until the branded patent expires, thereby assuring that Teva is the first generic to market. Or, if another company wins first-to-market 180-day exclusivity for a new generic drug, Teva will cut a deal to pay royalties to the other company, while they are allowed to create and sell their

own generic. S&P expects revenues to advance to over \$4.5 billion in 2004, sees Copaxone sales increasing 20%, and assigns a 12-month target price of \$88.

## **FINANCIAL**

**Capital One (COF \$70)** – Imminent interest rate hikes have prompted selling of most financial firms, including this credit card issuer, lowering its stock price substantially from its recent \$77 high. Higher short term rates really don't threaten Capital One's earnings though. The company has been diversifying and changing their business model. They recently switched their loan customer focus from the sub-prime segment to the super-prime segment, resulting in lower loan growth, but improved credit quality. Their international and auto-lending segments have been growing; and now CEO Richard Fairbank has announced that they will enter the banking business via an acquisition. Capital One's extensive database of information collected from its customer accounts distinguishes it from other financial services firms and gives it advantages in areas such as marketing and collection, which it does itself rather than outsourcing. Their database tells them which loans are likely to be profitable in pursuing recovery and which to charge off. Standard & Poor's has lowered its rating to Accumulate, as it sees the company's first quarter earnings a hard act to follow, but they have a 12-month target price of \$85.

**INDUSTRIALS** – Currently no stocks on list.

## **ENERGY**

**Nabors Industries (NBR \$41)** – Nabors is the largest oil and gas land drilling contractor, operating primarily in the U.S., but also internationally, with some offshore rigs in the Gulf of Mexico. Nabors has most of the idle rigs in the Rockies, where the exploration and production companies are drilling more to keep up with increased demand for natural gas. Drillers like Nabors and Patterson UTI, the two largest in America, are in position to charge higher day-rates for their rigs. The biggest risks to drillers are their dependence on high commodity prices and the depletion of deposits of that commodity. Although everyone is screaming about the high price of gas, it is much cheaper now, on an inflation-adjusted basis, than it was in 1990, the last time it sold for \$40 a barrel. So the price could easily continue higher. Consensus is that natural gas prices will stay high through 2004, and that drilling activity has not yet reached its peak. And yet with a forward P/E of 21, Nabors is trading well below its 5-year average P/E of 29.5. Standard & Poor's has a 12-month target price of \$53.

**Pioneer Natural Resources (PXD \$32)** – This independent, mid-cap oil and gas exploration and production company has announced plans to acquire Evergreen Resources, which owns coal-bed methane reserves in southern Colorado. Evergreen's assets are a good fit, providing pipeline quality natural gas in the U.S., and complimenting Pioneer's operations in the U.S., Canada, Argentina, several African countries, and its deepwater drilling in the Gulf of Mexico. This acquisition mitigates the risks and high costs associated with deepwater drilling,

but it came at a price (\$2.1 billion) many consider to be too high. The increased debt will be high, but the company has promised to pay down \$600 million by the end of 2005. Pioneer made good on its production prediction for the first quarter, coming in at more than 185,000 barrels per day. Earnings of \$0.50 per share and revenues up 55% were positive surprises and indicate there is plenty of cash to cover debt payments. Production is expected to increase 15% - 25% in 2004. Standard & Poor's has lowered their rating to Accumulate from Buy because of the added debt, but maintains a 12-month target price of \$38.

## **RETAIL/CONSUMER**

***Panera Bread Company (PNRA \$34)*** – These upscale, but casual bakery-cafes specialize in high-quality food for breakfast and lunch, founded on the concept that customers' preferences are changing from fast food to a more specialty dining experience. They feature fresh-baked goods, custom-made sandwiches (on fresh-baked bread), soups, salads, and fresh-roasted coffee and other beverages. The current low-carb fixation has hurt the restaurant some, but the recent high prices of butter and milk have hurt more. Their recently reported earnings were quite good, with revenues 28.9% higher than a year ago. But management expressed margin concerns due to the higher commodity costs and higher labor costs associated with opening new restaurants. These fears caused the stock to sell off 11%, creating an excellent opportunity to buy a well-run company with fine management and a great business model that has plenty of room to grow. They have about 640 bakery-cafes and intend to open 100 – 150 annually for the next several years. Annual revenue growth is anticipated to be about 23% over the next five years. Morningstar's fair value estimate is \$44. (One potential negative to future earnings is the extensive use of unexpensed stock options the company grants.)

***Sharper Image (SHRP \$28)*** – This micro cap specialty retailer's stock price dropped about 10% in May, a month in which the S&P was up slightly, and the Nasdaq (the exchange where SHRP trades) was up more than 3%. The problem was April same store sales decreased 3% from last April's sales, and investors feared this was a harbinger of more difficult comparisons. May comparable store sales were up 1%, a change in the right direction. The fundamentals are still good: zero debt, projected 20% annual growth, and P/E/G and price/sales ratios under 1. One caveat: consumer discretionary stocks tend to suffer from rising interest rates, as consumers cut the extra stuff from their budgets. I am not sure if SI's customers stop shopping, ever. Lastly, they introduced their iJoy Robotic Massage Chair, which now sells for under \$800, affordable to a broader market than its higher priced predecessors. The advertisement claims it replicates the four primary techniques of therapists: rolling, kneading, percussion, and compression. While at the S.I. corporate offices last week, I sat in this chair for a few minutes. I could not suppress oohing and aahing (rather loudly)—the things it did to my back were remarkably human-like for a chair!

**CHANGES TO PREVIOUS LIST (4/04)**

No companies were *removed* from the Recommendation List:

*Added* to the list was: *Amgen*.

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