

LIVING WITH LESS GROWTH, SHORTER NAILS

The market is overvalued. That has been the consensus opinion expressed for several weeks. It's a blanket statement, and it's unreasonable to lump fundamentally strong companies into the overvalued camp just because the market or their individual stock prices have gone up.

The market, as measured by the broad indices, has increased 2% to 7% from year-end to its peak January 26th—depending on the index—and some stocks *are* overvalued. But that doesn't mean there are no good investments to be found. However, once investor mentality locks onto a concept, it can become an epidemic.

Grappling with this “overvalued” mindset leads to nail-biting and the weakening of my convictions about whether or not to recommend what I think are good investments if I am fighting the market trend. Even from undervalued, solid growth stocks we might have to live with less growth, partially as a result of the self-fulfilling proclamation that *the market is overvalued*.

Nevertheless I present a list of companies that I think are worth buying now, with better than average growth outlooks, solid fundamentals, and reasonable prices:

TECHNOLOGY

Flextronics (FLEX) – This company has been on my list for a long time, inching up from \$12 to \$18, but 2004 could be the year it takes off. They not only reported stronger than expected quarterly earnings and revenues recently, they guided substantially higher for the full year. Not included in the new guidance is approximately \$2 billion in potential revenues from a possible deal with Nortel. Flextronics is the largest electronic contract manufacturer, and it generates about 70% of its revenues from China and other low-cost regions. It is a good way to participate indirectly in developing markets' growing prosperity. As a provider of a wide range of services to hardware companies, Flextronics should benefit from the growing trend toward outsourcing. The company should also benefit from the anticipated (and very long-awaited) recovery in the telecom industry.

L-3 Communications (LLL) – Returning to the list. I removed this company from my buy list in October only because I anticipated the government having to reduce its defense budget. The stock was at \$45 then, and is \$55 now. The company recently reported a 23% increase in 4Q net income, primarily from its defense businesses. They say there has been strong demand for their secure intelligence, surveillance and reconnaissance systems, simulation and training, and other defense products. In fact, the Homeland Security's Bureau of Immigration and Customs Enforcement just contracted approximately \$30 million to L-3 for ongoing maintenance and repair of their P-3 Orion aircraft fleet, which are used for aerial surveillance. L-3 expects sales to increase “in excess of 24%”

in 2004, and EPS to be up more than 20% from \$2.71 in 2003 to \$3.30 to \$3.35 in 2004.

UTStarcom (UTSI) – This telecommunication equipment company doubled its revenues in 2003, with 85% of revenues coming from China. Its Personal Access System (PAS) technology provides a mobile access network within a city or community, a fairly cheap service that is particularly attractive in developing countries where per capita income and phone line penetration are so much lower than in developed countries. About 30 million Chinese use the PAS as a fixed-line substitute, since they sometimes wait up to 10 years for a home phone. The company is focusing on rapid-growth telecommunications markets around the world, such as Viet Nam, where half of its 80 million people are under the age of 30. The company projects \$10 billion in revenues in five years, or more than 40% annual growth through 2008. UTSI was recently named to Forbes' "25 Fastest Growing Technology Companies" list for the second straight year.

TECHNOLOGY SERVICES

See Changes to the List below.

Comcast (CMCSK) – With more than 21 million subscribers, Comcast is the largest cable operator. 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 such as internet access. Broadband has become a key advantage over satellite services, providing customers with *both* cable TV content and broadband. They have also announced that a TiVo-like video recording feature will soon be available to their customers. Their balance sheet has improved because of asset sales, such as QVC, which have reduced debt to \$23 billion from \$35 billion after the ATTB acquisition. Comcast still owns \$1.5 billion in Time Warner stock, \$1.3 billion in Liberty Media stock, and a 21% interest in Time Warner Cable. Revenues are estimated to grow 12-13% in 2004. When you look at the GARP stats on my list, Comcast does not pass the test, partly because of difficulties with post-merger numbers. But management has such a great track record, and they have done what most thought impossible with ATTB: increased EBITDA margins from 22% to 33%; increased operating cash flow per subscriber from \$205 to \$274; and turned huge customer losses at ATTB into sizable subscriber gains.

HEALTH CARE

Biogen IDEC (BIIB) – This recently merged company now has the expertise and infrastructure for both cancer-fighting drugs and auto-immune therapies. Rituxan, the firm's cancer drug for non-Hodgkin's lymphoma, has met its Phase III efficacy endpoint early and will be put on the fast track for FDA approval. Standard & Poor's estimates \$1.53 billion in U.S. Rituxan sales in 2004. They anticipate \$1.22 billion globally from sales of Avonex (multiple sclerosis), \$91 million from Amevive (psoriasis), and \$36 million from Zevalin (non-Hodgkin's lymphoma). Promising preliminary results for Amevive's systemic treatment of moderate-to-

severe chronic psoriasis are good news for the company and the 4.5 million U.S. adults affected by the disease. The firm is expected to file for approval of Antegren for treatment of multiple sclerosis, maybe as soon as this spring. Some feel the stock price has already assumed this approval. Standard & Poor's \$54 target price is based on approval by 2006. Biotech stocks can be quite volatile and could be hurt by a market that "is overvalued".

Cardinal Health (CAH) - This diverse health care company consists of four segments: pharmaceutical supply and distribution, medical and surgical products and services, pharmaceutical technologies and services (PTS=biotech), and automation and information services. Cardinal Health has been aggressively adding to its high-growth manufacturing segment (PTS) through acquisitions—half of its acquisitions in the past three years have been drug development and manufacturing companies, including most recently Intercare Group in Europe. The company has plenty of free cash, and a healthy balance sheet, which will allow it to repurchase \$1 billion in stock and continue investing in its manufacturing segment. S&P projects operating revenues to grow 14% to 15% in 2004 and has a price target of \$75.

Laboratory Corp. of America (LH) – Lab Corp. provides clinical diagnostic testing services through a national network of laboratories for more than 200,000 physicians and other health care providers. Their 47 labs and 1,200 service sites perform over 4,000 different clinical laboratory tests involving human bodily fluids and tissues. The company is a pioneer in commercializing new diagnostic technologies and plans to continue expanding its esoteric, gene-based, and molecular testing business, as these procedures are more profitable than routine analyses. Standard & Poor's projects a 6% rise in revenues in 2004 to \$3.15 billion, up from just under \$3 billion in 2003; and earnings to increase 15%, more than the S&P 500's 14%. Therefore, their target price for the company is \$51. Other positives for the company include growing cash flow, which can be used for further genomic testing acquisitions and a planned stock buyback; job growth; and absence of lab co-pay language in the new Medicare legislation.

Pfizer (PFE) – This company has also been on my list for a long time, but 2004 could be the year we see its stock price back up in the mid-40s. Recent FDA approval of two new drugs, Caduet and Spiriva, add two more potential \$1 – 2 billion blockbusters. Caduet is a combination pill (containing Norvasc and Lipitor) for treatment of both high blood pressure and high cholesterol. Spiriva is an inhaler for the treatment of chronic bronchospasms. Pfizer has more than 200 new drugs in development, and its two biggest, Viagra and Lipitor, are not facing patent expiration any time soon. Management expects earnings to be up 21% in 2004 over the 12% increase in 2003. Standard & Poor's estimates sales to increase 16% in 2004. S&P also sees Pfizer as a beneficiary of new Medicare legislation because it has so many drugs that focus on conditions affecting the elderly, such as cholesterol, heart disease, and arthritis.

Teva Pharmaceutical (TEVA) – Teva is the largest supplier of generic drugs, makes bulk pharmaceutical chemicals, and has a successful proprietary drug, Copaxone, an injectable treatment for multiple sclerosis. They have 68

Abbreviated New Drug Applications (ANDA) currently under review by the FDA, 18 of which have first-to-file status, with the potential of six months market exclusivity. Teva is one of the most profitable firms in the generic sector because of volume sales and operating synergies from recent acquisitions. The company currently has generic equivalents of Serzone antidepressant, Wellbutrin antidepressant, Neurontin anticonvulsant, Monopril and Accupril antihypertensives, and Ribavirin antiviral agent. S&P expects revenues to advance over 20% in 2004 and values the company at \$69.

FINANCIAL

Capital One (COF) – Even though this credit card issuer passes most of my GARP criteria, it is one of those “overvalued” nail-biters, as the company is up more than 100% in the last year. However, the company has recently switched their customer focus from the sub-prime segment to the super-prime segment, which will lower loan growth, but also decrease delinquency and loan loss, while credit quality improves. Standard & Poor’s still sees loan growth at 15% and earnings growth at 14% for 2004. They estimate eps of \$5.60 for 2004 and \$6.30 for 2005. Based on a 13.5 multiple of 2005 earnings, S&P has a target price of \$85. This stock has a history of volatility—it could get cheaper before reaching new highs—but I think management will use their cost efficiency and customized approach to acquiring customers to continue their excellent track record.

INDUSTRIAL

See Changes to the List below.

ENERGY

Nabors Industries (NBR) – Nabors is the largest oil and gas land drilling contractor, mostly in the U.S., but also internationally, with some offshore rigs, primarily in the Gulf of Mexico. Since most of its rigs drill for natural gas in America, and natural gas is expensive to transport, Nabors is conveniently located near the largest gas market. The biggest risks to drillers are that they depend on high commodity prices and depleting deposits of that commodity. Consensus is that natural gas prices will stay high through 2004, and that drilling activity has not yet reached its peak. The company has grown rapidly, mostly by acquisitions, and has posted a profit the last twelve years. (Worth mentioning: the CEO has maintained a modest \$325,000 salary since coming on board in 1987.) Standard & Poor’s has a 12-month target price of \$53, based on 13 times their annualized operating cash flow estimate.

RETAIL/CONSUMER

Outback Steakhouse (OSI) – This chain of casual dining restaurants has survived the mad cow scare. They have historically been able to increase same-store sales during tough times, and the company has increased revenues for the last 10 years. The current high-protein diet trend should be a positive for the

steakhouse. They have been innovative in keeping down costs, while keeping customers happy—they pioneered take-away service and call-ahead seating. I expect growing consumer confidence, spending, and family income will boost revenues at their popular restaurants. My buy recommendation is at odds with analysts' consensus Hold (and S&P's Avoid) ratings. I base my optimism on Outback's superior fundamentals to its industry peers: higher profit margins, greater returns on equity and assets, zero debt to equity, lower price to sales, a lower P/E, and growth anticipated to be 15% annually over the next five years, vs. less than 14% for peers. Not a high flyer, but a consistent grower that is managed quite well.

Panera Bread Company (PNRA) – added today. These bakery-cafes specialize in high-quality food for breakfast and lunch, with 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. They have about 150 company-owned bakery-cafes and more than 400 franchised bakery-cafes. They intend to open 100 – 150 annually for the next several years. Annual revenue growth is anticipated to be between 24% and 30%. Although the company has not yet been hurt much by the current low-carb diet trend, they are testing some low-carb sandwiches and breads and may add them to their menus later this year. The company only became Panera Bread in 1999—before that it was Au Bon Pain—and has increased revenues the last three years.

Sharper Image (SHRP) – This micro cap specialty retailer was trading around \$20 per share when I began recommending it last April. It was \$39 two days ago before selling off \$4, because “it is overvalued”. The fundamentals are still good: zero debt, projected 20% annual growth, and a price/sales ratio of 1.1. Same-store sales for January were up 21%. The company has raised full-year earnings guidance twice in less than two months, to \$1.63 - \$1.65. The growth strategy centers on opening new stores and expanding its proprietary product offerings: the Sharper Image Design and branded products. They plan to add 25 new stores in 2004 and project 15% to 20% new store unit growth. The products it sells are upscale, innovative and usually cannot be found elsewhere. Internet sales have been increasing and becoming a larger portion of overall revenue. International web sites and other internet-based marketing strategies are also being considered to continue this trend. I am leaving this stock on my buy list, but with the caveat that share price may struggle against the “overvalued” call.

CHANGES TO PREVIOUS LIST (12/03)

Two companies, First Data and Lennar, have been **removed** from the Recommendation List:

TECH SERVICES

First Data (FDC) - is a leader in credit and debit card issuance and processing services and money transfer processing, specifically by Western Union, which it

owns. Western Union, which generates lots of cash for the company, has been expanding into China and India, where they now have almost 20,000 agent locations. They are also acquiring Concord EFS, a PIN-debit system that allows customers to purchase goods by swiping a debit card and punching in a PIN, the fastest growing of all electronic transactions. I am removing FDC from the list mostly because of uncertainties surrounding Concord EFS. They have recently lost a number of large customers, including Wachovia, Wells Fargo, US Bancorp, and Bank One. Plus, the recently announced merger of JP Morgan and Bank One opens up questions about which card issuer, payment processor, and PIN-based debit network will end up with the combined company's businesses. And most recently the Department of Justice has issued a request for information from Western Union for a civil antitrust investigation regarding contractual practices between Western Union and its money transfer agents. I have not yet decided to sell my shares, as First Data is not over-priced and has a long history of increasing revenues. But I am leaning that way.

INDUSTRIAL

Lennar (LEN) – This homebuilder, which recently split 2-for-1, is up nearly 100% this year, but it is the top nail-biter. Below are remarks made by Briefing.com in December, after Lennar reported great earnings, which explain why I feel I cannot recommend this fundamentally sound company for purchase right now:

“Mid-cap homebuilder Lennar Corp (LEN) was the latest in a string of homebuilders to turn in a solid earnings report, but find little stock upside from the news. 4Q03 (Nov) home deliveries rose 14% and fueled a healthy 12% increase in homebuilding revenues, to \$2.70 bln. . . . Citing its record backlog and strong balance sheet (cash outstanding runs at approximately \$14/share), the company increased its FY04 (Nov) EPS goal to \$10.50 from \$9.50 and established a FY05 EPS target of \$12.00. . . . Lennar's impressive visibility into the next two years have fallen on deaf ears on Wall Street, and Briefing.com believes the inaction on the part of investors lies with the uphill battle facing the homebuilding group. The specter of rising mortgage rates has cast a pall over the sector's phenomenal economic and company-specific results. The need to show selectivity in the coming months - with the indices' setting a course of 52-week highs - has left groups like homebuilding - who have viable risks over the intermediate-term - on the losing end of this battle for buying interest.

We don't believe that LEN shares will be treated any differently as the market assumes a more neutral stance towards the sector.”

I have sold more than half of my shares, but kept some, because the fundamentals tell me the stock should do well.

Added to the list was: ***Panera Bread Company.***

Returning to the list was: ***L-3 Communications.***

Linda Stewart for www.fizone.com
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