

CHINA PLAYS, OTHER STOCKS TO OWN IN 2004

There is no doubt that China's economy has been rapidly growing, with and because of cultural changes. In their quest for more jobs and a higher standard of living, they have become the manufacturing hub of the world. Corporate China has been driving up raw material prices as they increase output to meet the increased demand. Low interest rate policy has been a great incentive for Chinese companies. I have read that now only 12% of businesses are state-owned, down from 45% in 1995. While I do not feel comfortable recommending foreign stocks, some of the stocks on my recommended list are clear beneficiaries of the growth engine that is China: Flextronics, UTStarcom, and First Data.

Given that the U.S. economy is likely to continue on its growth path, not at the 8% growth rate reported for third quarter GDP, but at a consistent, more modest rate, at least through 2004, I have compiled a list of companies to own in 2004 with better than average growth outlooks, solid fundamentals, and reasonable prices.

The list is longer now than in October, as I have added four stocks and removed only one. (Two of those added are not new, but returning to the list.) Changes are explained at the end of my current Recommendation List:

TECHNOLOGY

Flextronics (FLEX) – This company 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. After three years of negative earnings per share, the firm is expected to earn \$.35 per share for fiscal 2004 (ends in March). It has increased revenues each of the last five years and is estimated to grow earnings 21% annually over the next five. This stock's performance, despite its low-cost and size advantages, will depend on a technology turn-around.

UTStarcom (UTSI) – This telecommunication equipment company makes switches and software for service providers that facilitate migration between protocols, such as wireline to wireless or narrowband to broadband. The beauty of UTSI's technology is that it allows phone carriers, using legacy systems, to cost-effectively and seamlessly upgrade their service offerings to include data, video, and wireless networks. 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 phonline penetration are so much lower than in developed countries. China currently has around 30 million PAS subscribers, up from 12 million in 2002. The company is focusing on rapid-growth telecommunications markets around the world, such as Viet Nam, half of whose 80 million people are under the age of 30. Earnings per share are projected to grow almost 20% in 2004 over 2003, and analysts estimate 23% annualized long-term growth, much higher than the industry average of 15%.

TECHNOLOGY SERVICES

Comcast (CMCSK) – Returning to list - A year ago Comcast had just completed the merger with AT&T Broadband (ATTB), and the company was on my recommended list. But most analysts felt they had paid way too much for ATTB, which had lost 481,000 subscribers in 2002, and they took on \$20 billion of ATTB debt. The stock was trading around \$24 in February, when I removed them from my list because of too many uncertainties. Since then Comcast management has cut costs, increased operating cash flow per subscriber, and added over 100,000 subscribers at the acquired ATTB systems. After jumping to \$28 at the end of February, the stock has been trading between \$28 and \$30 the last ten months. With more than 21 million subscribers, Comcast is the largest cable operator. Revenues are estimated to grow 12-13% in 2004, which will no doubt be helped by the TiVo-like video recording feature they recently announced will soon be available to their customers.

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. They are also acquiring Concord EFS, a PIN-debit system that allows customers purchase goods by swiping a debit card and punching in a PIN, the fastest growing of all electronic transactions. 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. Not only are these developing markets attractive for business growth, the foreign currency spreads represented 10% of FDC's revenue. The Payment Services (non-bank money transfer) segment accounts for 39% of revenues; Merchant Services (merchants' credit and debit card transaction processing) accounts for 34%; and Card Issuing Services accounts for 24%. Standard & Poor's expects EPS to grow 14% annually over the next three years and has a 12-month target price of \$51.

HEALTH CARE

Biogen IDEC (BIIB) – Returning to the list. IDEC Pharmaceuticals was on my recommendation list until October, after which they merged with Biogen, a much slower growth biotech firm. Idec was growing at 22% annually, Biogen at 14%, and the combined company is forecast to grow at 18% annually. Idec's focus was on cancer-fighting monoclonal antibodies, looking to enter the auto-immune arena; Biogen's focus was auto-immune therapies, with early stage research in oncology. The new company now has the expertise and infrastructure for both endeavors without further capital expenditure. 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 Rituxan sales in 2004. Other drugs include Avonex (multiple sclerosis), Amevive (psoriasis), and Zevalin (non-Hodgkin's lymphoma), with estimates of \$1.22 billion, \$91 million, and \$36 million respectively.

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), and automation and information services. The most growth comes from its biotech segment (PTS), which Cardinal Health has been aggressively adding to through acquisitions—half of its acquisitions in the past three years have been drug development and manufacturing companies. Cardinal has a big competitive advantage because of its low-cost structure and its operational diversity, allowing it to increase its market share. It also has plenty of free cash, and a healthy balance sheet. S&P projects in excess of 50% gains from PTS, and consensus overall long-term growth is 17%.

Laboratory Corp. of America (LH) – added to the list today. 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. Revenue for 2002 was \$2.5 billion, and Standard & Poor's projects \$3 billion in 2003 and \$3.15 billion in 2004. 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. The company also develops alliances with hospitals that outsource their lab testing. Analysts estimate 17% annualized growth over the next five years. Standard & Poor's expects earnings to rise 15% in 2004 and has a 12-month target price of \$42.

Pfizer (PFE) – This company may be the most compelling buy on my list. While the Dow has gone up more than 27% year to date, and the Nasdaq more than 40%, Pfizer has increased less than 12%. Other major pharmaceuticals have also lagged the broader market, but they have less going for them than Pfizer does. Pfizer has more than 200 new drugs in development, and its billion dollar blockbusters, such as Viagra and Lipitor, are not facing patent expiration any time soon. The merger with Pharmacia, making the new company the largest drug maker, is now complete and is expected to cut costs by \$3 billion in 2004. Management expects earnings and revenues to be up 23% and 21% respectively for 2004 over 2003.

Teva Pharmaceutical (TEVA) – Teva is the largest supplier of generic drugs, makes bulk pharmaceutical chemicals, and they have 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

seems to have been successful in forging agreements with major drug companies, when the patent on one of their drugs is close to expiring. In these deals Teva markets the generic version and shares revenues with the bigger company. S&P expects revenues to advance over 20% in 2004 and values the company at \$69.

FINANCIAL

Capital One (COF) -- This credit card issuer is up more than 100% this year. They have grown assets by 34% annually over the last 5 years. As a Morningstar analyst said, [their] "excellent track record hasn't occurred by coincidence." So, at \$60 a share, a P/E of 12, and 16% annual growth anticipated, it is not over-priced relative to its growth estimate. However, I have some concern that investors, who in the past have bought the stock as a growth stock, are less likely to be buyers now that the company has estimated growth for 2004 at 15% - 20%, half its historical rate. The lower growth is the result of their strategy switch to focus on the prime customer segment, instead of the sub-prime. Profit margins will be lower, but so will costs. 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

Lennar (LEN) – This homebuilder is up approximately 100% this year, and the company recently raised their EPS estimate for next year to \$10.50 from \$9.50, and to \$12 for 2005. They also announced a 2-for-1 stock split for owners as of January 6, 2004. New home orders were up 22% in the third quarter. S&P predicts home sales will rise 13% in 2004, and mortgage rates will remain buyer friendly at least through 2004. They view Lennar's business model as the top one in the sector. The company offers a diversified line of homes, from first-time buyers to move-up and active adult buyers. They sell homes using two different marketing strategies: one is an "everything's included" system, in which the most popular options and upgrades are standard; the other offers buyer design programs, which results in more customized homes. They also have a financial services division, which experienced a decline in earnings in the fourth quarter because of fewer refinancing transactions, a trend that will most likely continue into 2004. Still, the company has a record backlog going into 2004, and a strong balance sheet.

ENERGY

Nabors Industries (NBR) – added today – 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. In 2002, 68% of revenues came from drilling, but the company also offers well site services, such as engineering, construction, and transportation. They own nearly 600 land drilling rigs and 900 well site

servicing rigs, 43 platform (marine), 16 jackup (marine), and three barge rigs. 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.) Land rig utilization is anticipated to increase in 2004, as are the prices of oil and natural gas. Five-year annualized growth for Nabors is estimated at 19%. If this winter continues its early colder trend, we could see drilling activity in 2004 increase at least 10% to 12%, because of already lower natural gas reserves and the resulting higher gas prices, according to Banc of America Securities analyst James Wicklund.

RETAIL/CONSUMER

Outback Steakhouse (OSI) – This chain of casual dining restaurants has a couple concerns in its near future: will mad cow disease become a serious threat to our food chain and eating habits, as it did in England?; will the expected higher food and labor costs take too big a bite out of profit margins? On the first issue, it's too early to know the answer, but, if there is only the one diseased cow, as there was in Canada in May, the impact will be brief and shallow. In that case, the current high-protein diet trend should be a positive for the steakhouse. Regarding margins, they have been innovative in keeping down costs, while keeping customers happy—they pioneered take-away service and call-ahead seating. They have been able to increase same-store sales during tough times. I expect growing consumer confidence, spending, and family income will boost revenues at their popular restaurants. Growth is anticipated to be 15% annually over the next five years, and the company has increased revenues for the last 10 years. Not a high flyer, but a consistent grower that is managed quite well.

Sharper Image (SHRP) – This micro cap specialty retailer sells merchandise at its 140 company stores, through its catalog, and on the internet. The products it sells are upscale, innovative and usually cannot be found elsewhere. 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. 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. Because of excellent holiday sales—same store sales increased 21%--the company has raised its guidance for 4Q and for the full fiscal year twice in the last two months, now estimating \$1.34 to \$1.38 and \$1.57 to \$1.61 respectively.

CHANGES TO PREVIOUS LIST (10/03)

Only one company, Autozone, was **removed** from the Recommendation List:

RETAIL/CONSUMER

Autozone – I am removing this national leader in retail auto parts, partly because their same-store sales growth was only 1% in their most recently reported

quarter. More importantly I believe there will be—in fact, already has been—a shift in consumer spending, away from the repair your old car to buy a new one with zero percent down and zero payments until 2005. With this kind of financing available to consumers and the likeliness of jobs growth fueling even more new car buying, I anticipate more slowing for this industry and for Autozone. The company has increased revenues in each of the last ten years and had consistently exceeded earnings estimates in recent quarters *until this last quarterly report*. Because it is unusual for the company to miss estimates and because their stellar past performance has made year-over-year comparisons difficult, investors slammed the stock, knocking it down 10% in one day. This could be a good buying opportunity, but I expect the stock price to languish, and I will wait to see how next quarter's revenue comes in.

Added to the list were: **Laboratory Corp. of America** and **Nabors Industries**.

Returning to the list were: **Comcast** and **Biogen IDEC**.

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