

Chips: Upturn in Sight?

By Monica Rivituso

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SEEMS THERE'S STILL more dip to come for chips.

<http://www.smartmoney.com/sectorpatrol/index.cfm?story=20050126>

Investors with sizable positions in semiconductor stocks had a rough time of it last year, with shares of Intel (INTC1), Texas Instruments (TXN2) and STMicroelectronics (STM3) declining 27%, 16% and 28%, respectively.

It's not that the industry had a lousy 12 months, mind you; quite the contrary. On the heels of 18% industry revenue growth in 2003, chip makers in 2004 could see 27% to 30% growth after final numbers are tallied. But the stock market has a way of discounting the inevitable in the chip biz: the bust following a boom. And the bust's a comin', according to analysts.

The Semiconductor Industry Association estimates that chip sales will downshift to essentially zero growth this year. Analyst forecasts are all over the map, from a fall of 5% to a rise of 8%. Bottom line: growth will slow precipitously this year. And when it comes to chip stocks, debating how dramatic the slowdown will be is splitting hairs. Chip investors already bailed last summer, at the first whiff of deceleration.

The industry's bad news has started trickling out. Chip inventories are building, average selling prices are declining and companies are prepping investors. On Monday, German chip maker Infineon Technologies AG (IFX4) warned that its fiscal second-quarter earnings would fall short amid lackluster industry demand. Advanced Micro Devices (AMD5) recently posted weaker-than-expected fourth-quarter results and said pricing pressures and an imbalance between supply and demand would crimp first-quarter results. Earlier this month, Micrel (MCRL6) warned that fourth-quarter revenue would come in lighter than expected, on weak demand. Xilinx (XLNX7) likewise warned of a revenue miss, citing weak orders.

Some companies are downsizing operations to become nimbler or focus on more-profitable products. In recent weeks, chip makers National Semiconductor (NSM8), Cypress Semiconductor (CY9) and LSI Logic (LSI10), as well as chip-equipment giant Applied Materials (AMAT11), have announced job cuts.

The chip industry is notoriously cyclical, which is why these stocks don't tend to be of the long-term, buy-and-hold variety. Ben Lynch, analyst at Deutsche Bank, was bearish on the sector last year and continues to be so. He's forecasting a 23% earnings contraction for companies comprising the benchmark Philadelphia Semiconductor Index. "Generally, we believe there is still more downside to semiconductor earnings forecasts for 2005 and that's probably the greatest source of risk for [these] stocks," he says.

It's tough to predict with any precision when a chip downturn will bottom, but slumps tend to last 12 to 18 months from peak to trough. Deutsche Bank's Lynch figures the industry should bottom late in the third quarter of this year. Phoenix-based chip research firm Semico Research has similar expectations.

Of course, the stock market tends to anticipate news rather than follow it, as our chart below indicates. Note that upturns in chip stocks often occur well before sales growth resumes — that's typical for chip

cycles. If market watchers are right that sales will bottom sometime around September, that could mean an upturn in the stocks isn't far off. Lynch expects SOX to bottom late this quarter, or early in the second quarter.

Meantime, there could be a few selective opportunities out there. "In this type of environment, we prefer larger-cap names that are more stable and have more attractive businesses [compared with their peers]," says Amrit Tewary, analyst at Standard & Poor's. He recommends focusing on companies that have exposure to diversified end markets, financial flexibility and a good amount of cash on the balance sheet. Companies with exposure to high-end products aren't as susceptible to pricing pressure, which helps keep margins stable, he adds. Two stocks that fit this bill, according to Tewary: Linear Technology (LLTC12) and Maxim Integrated Products (MXIM13). "We see well-above-average [stock] appreciation potential [for both] in the next 12 months," he says. "And we think they're going to outperform competitors in the industry."

Both companies specialize in high-end analog chips for consumer, industrial, communications and computing products. Converting "real-world" signals and sounds into digital requires analog chips. And as newer, flashier digital gadgets hit the market, more sophisticated analog chips will be required, too. Tewary uses a blended approach to arrive at target prices for stocks, examining price/sales, price/earnings and a handful of historical metrics. He has a \$50 12-month price target on Linear shares, which recently traded below \$38, and a \$60 target on Maxim (recent price: \$39). (Tewary does not own shares of either stock; Standard & Poor's does not do investment banking.)

Deutsche Bank's Lynch favors one stock in the sector: graphics chip maker ATI Technologies (ATYT14). He expects the company to increase revenues by close to 30% this year, far outpacing the industry. ATI is gaining market share and providing chips for new products, such as digital televisions and cellular phones, according to Lynch.

And ATI's valuation isn't too stretched, he adds. Lynch likes to examine chip stocks on a price/sales basis, since they tend to look most expensive on a P/E basis at a cycle's trough (when earnings are at their lowest) and least expensive at the peak (when profits are robust). "That leads you to draw completely wrong conclusions on the stocks," he says. "Price/sales takes that distortion away."

Shares of ATI trade at 1.6 times forward price/sales, according to Lynch. That's lower than its historical average of 1.7 and far below the industry's current average of about 3.8. Lynch has a \$23 price target on the stock, roughly \$6, or 35%, above its current level. (Lynch doesn't own shares of ATI; Deutsche Bank doesn't have an investment-banking relationship with the company.)

Chip Flip

The first graph shows the Philadelphia Semiconductor Index's daily movements. The second shows the three-month moving average growth of worldwide chip sales.

Sources: Philadelphia Stock Exchange, SIA

1<http://www.smartmoney.com/cfscripts/Director.cfm?searchString=INTC>

2<http://www.smartmoney.com/cfscripts/Director.cfm?searchString=TXN>

3<http://www.smartmoney.com/cfscripts/Director.cfm?searchString=STM>

4<http://www.smartmoney.com/cfscripts/Director.cfm?searchString=IFX>

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