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BARRON'S ROUNDTABLE

Paul Wick: How to Play the Big Trends in Tech

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PHOTO: JEREMY LIEBMAN FOR BARRON'S

Barron's: Paul, welcome aboard. What in your world looks enticing to you?

Paul Wick: Before I get into individual stocks, I'd like to give a quick industry overview. We've been bullish on semiconductor stocks for quite some time, certainly for the past three or four years. One of the things I come back to is that semiconductors are an inexpensive way to play a lot of the best secular trends in technology, including the cloud, the amount of compute

power in the cloud, storage needed in cloud data centers, memory for virtualization, and higher-speed networks to reduce latency to the cloud.

Semiconductors are also key for the trends happening with the move to electric vehicles and plug-in hybrids, for autonomous driving and safety in automobiles, and for artificial intelligence and the Internet of Things. Semiconductors are levered to all those trends, yet the stocks trade at meaningfully lower valuations than quite a few other parts of tech. Semis also are meaningfully cheaper than industrials, beverages, medical tech, and the broad market.

The chip industry has had a lot of consolidation. When acquirers have bought other chip companies, they have realized significant cost synergies, and their stocks have gone up. So now the industry has a mentality of buy someone or get sold. That is going to continue for a while, and is part of why I am excited about the industry. Chip stocks are highly correlated to economic growth globally, which we have in abundance right now. And, chip stocks tend to do reasonably well in a rising interest-rate environment.

That's an excellent introduction. Now, let's have your favorite names.

Wick: I'll start off with some long ideas in semiconductors. Micron Technology [ticker: MU] reported earnings a few weeks ago. The company significantly exceeded expectations. It is growing revenue by more than 50% a year. In fact, over the past couple of years, revenue has grown by more than 100%. And Micron's profit margins have expanded significantly. Operating margins are now in the high-40% area.

What has been driving margins up?

Wick: Partly, the cost to add new leading edge capacity has gotten so high that people aren't adding new capacity as easily as in the past. You can't just buy a new lithography tool, turn it on, do a node shrink, and have 30% or 40% more bits anymore. Now you get 10% more bits, or at most 15% more bits.

There are three main players in DRAM [dynamic random access memory]: Micron, Samsung Electronics [005930.Korea], and SK Hynix [000660.Korea]. In NAND flash [used for storage in smartphones and laptops], Samsung is No. 1, with Toshiba [6502.Japan] and Western Digital [WDC] close behind, followed by Micron and Hynix again. Intel [INTC] is peripherally involved, mostly through a joint venture with Micron. A few years ago, Micron got behind the curve manufacturing-wise. It caught back up, and that is one reasons margins have exploded.

How has the memory industry evolved?

Wick: If you think back to 20-odd years ago, the DRAM industry was all about PCs—new operating systems and new Intel processors. Now, PC DRAM is only about 20% of demand. The demand drivers are much more diverse. Mobile phones are 20%. Servers and data centers are probably 25% to 30%. Then there's TVs and consumer electronics; it is getting really pervasive. Even automobiles have meaningful memory content.

The demand from cloud data centers is inelastic because people with high-margin businesses like Google or Facebook [FB] don't really quibble about the cost of memory. It's not like Dell Computer 25 years ago; it would have killed to save 10 cents on a DRAM module. Micron is earning about $11 to $12 a share per year. The stock is about $45, which means people don't think the good times are going to last.

Why do you think they will continue?

Wick: I don't know whether the current degree of profitability is sustainable, but we aren't going to get down to a cyclical low with the companies losing money again. The balance sheet has been cleaned up. Micron generated $1.7 billion in free cash flow in the latest quarter. The annualized free cash flow is about $7.5 billion to $8 billion. The enterprise value is about $53 billion. There is a little more delevering to come. They'll probably pay down another $2 billion or so of debt and then announce a meaningful share repurchase and capital return later in 2018.

What could Micron earn at the cycle trough?

Wick: That's hard to say—I'd guess $4 a share or thereabouts.

Oscar Schafer: Regarding timing, will people buy the stock once the cycle starts down?

Paul Wick

Portfolio manager, Seligman Tech. Fund Team

Columbia Threadneedle Investments

Boston

Wick: These stocks could get rerated dramatically higher. Things like artificial intelligence and autonomous cars are going to require a vast amount of memory. Yet the perception is that we still have the memory market of 15 or 20 years ago. The key thing is that the cost of new capacity has tripled in five years, and that changes everything.

Micron has a great CEO, Sanjay Mehotra, who had been CEO of SanDisk. He inspires confidence. The stock could be $60, $70, $80 over the course of the next year. I like the risk/reward, and if I'm wrong, it doesn't go down a lot.

What else do you like?

Wick: Western Digital is the old Western Digital magnetic disk-drive company that competed with Seagate Technology [STX] before acquiring SanDisk. The way to think about the company is, it is half disk drive and half flash memory. I recommended Western Digital, along with Micron, in an interview in Barron's in April. Micron is up significantly since, whereas Western Digital has gone sideways. Part of that is NAND flash prices have been fairly flat, and recently softened slightly. Also, Western Digital got into a dispute with its joint-venture partner, Toshiba, over Toshiba possibly selling a stake in Toshiba memory to either Western Digital or other companies. They've buried the hatchet and extended the terms of the joint venture out to 2029, I believe.

View Paul Wick's Picks

Western Digital announced that in early December. At the same time, the company reiterated that it would earn more than $13 a share in the June 2018 fiscal year. The stock is around $80 a share. It is trading for six times earnings.

What does the balance sheet look like?

Wick: Western Digital has a lot of debt on the balance sheet, but the company generates a prodigious amount of free cash flow per year—north of $3 billion a year. They have some high-cost debt, and will significantly delever the balance sheet in the next couple of years. They even have some debt that has 10% coupon rates on it that's callable in April 2019. That will get called. You are going to see share repurchases, as well. The valuation is just too low. Again, there is a perception that if flash prices fall, somehow the P&L [profit and loss] statement of the company has to get obliterated.

Management said a few weeks ago that the company would be above its target profit margins for all of calendar 2018, a pretty confident statement.

How high could Western Digital's stock go from here?

Wick: The stock could go to $120. It is amazing to me that Seagate trades at a premium to Western Digital, given that Seagate is pretty much a pure magnetic disk-drive company. Inevitably, over time, magnetic disk drives are going away. At least with Western Digital, they have future-proofed the company to some degree by having flash memory as well as magnetic storage.

Marvell Technology Group [MRVL] is another chip company we like. Marvell had a management change a year and a half ago. The founding CEO was pushed out, along with his wife. They were optimistic about a lot of research-and-development projects, and they had a lot of dry holes, including a baseband processor business into which they sunk hundreds of millions of dollars and got nothing in return.

Rick Hill took over as chairman of the board and brought in a capable CEO, Matt Murphy, from Maxim Integrated [MXIM]. In just two years Marvell's gross margin has gone from 53% to 61%. The R&D spending that had been 36% to 40% of revenue is now 30%. And the operating profit margins, which had gotten as low as single digits, are now back up in the high-20% area. It has been a pretty solid turnaround. They've divested some unprofitable businesses and executed well.

Tell us more about Marvell's products.

Wick: Marvell makes disk-drive controllers for both magnetic disk drives and solid state drives. This is a high-margin business—maybe as high as 70% gross margins. That's about 55% of the company's revenues. They also have a connectivity business, making Wi-Fi, Bluetooth-type products, mostly for game controllers. Microsoft Xbox is their marquee customer. Then they have a networking chip business that has lost share for the past decade to Broadcom [AVGO]. It recently has been doing better but had been sinking for a long time.

One thing we like about Marvell, in addition to the fact that the company has turned its business around, is that it is buying Cavium [CAVM]. Cavium has been one of the best network processor companies in Silicon Valley. It has processors for wireless infrastructure equipment, security firewall appliances, and enhanced security of data centers. Cavium has a fast-growing ARM microprocessor family called Thunder X that has gained traction at a few cloud customers. The company has ethernet switch chips, and a year and a half ago, it bought QLogic, which gave it ethernet and fiber channel adapters. That will be synergistic with Marvell's storage-related business.

What does the balance sheet look like?

Wick: Marvell has $1.7 billion or $1.8 billion of cash, and is paying about $5 billion for Cavium—half cash and half stock. It ended up taking on debt, but it is manageable.

Marvell has excess real estate, so it can move Cavium's employees to its campus and cut costs. While Marvell's networking business has been steadily losing share, Cavium's networking business is world class. By putting the two companies together, you should get a significant amount of R&D savings.

Marvell is trading around $23 a share. The deal should close around midyear. Earnings per share for calendar 2019 could be in the neighborhood of $2. The stock should trade for between 15 and 20 times earnings, so that puts the price of Marvel at $30 to $40 a share a year or so from now.

What else do you like?

Wick: Moving out of chips, Oracle [ORCL] could have a Microsoft [MSFT]-like revaluation. The company is doing well in its core database business. It has a new product cycle with Oracle 12c, which is in the early innings. The stock hasn't done much over the past few years, even though the earnings have been pretty solid. There's a perception that Oracle's cloud efforts are too little, too late. That is unduly harsh.

The stock is trading for about $48 a share, and the company has a $190 billion enterprise value. Oracle is generating about $15 billion a year in free cash flow. It is a beneficiary of tax

reform, and will see a 30- or 40-cent increase in earnings per share from tax reform. The company could earn around $3.63 a share in calendar 2019.

Some people say Amazon is going to pose a competitive problem for Oracle. But Salesforce.com [CRM] has its mission-critical apps running on Oracle under about a nine-year license agreement. Amazon runs its core business off the Oracle database. But for many non-mission-critical applications, you don't need as expensive a database as Oracle's. Other databases, such as Microsoft SQL Server and MongoDB [MDB], are good enough.

What could get Oracle's stock moving again?

Wick: The company has a lot of cash offshore. Share-repurchase activity could go from $10 billion a year to $13 billion-$14 billion. With the valuation modest, revenue growing by mid-single digits over time, and a weaker dollar helping, you could see a revaluation higher. Oracle trades at a lower free-cash-flow multiple than IBM [IBM]. And IBM is a sinking ship in comparison to Oracle.

Scott Black: I've been out to see Oracle. We sold the stock at around $41 a share more than a year ago. Cloud computing was only 6% of revenue at the time. Software-as-a-Service doesn't make up for the fact that people don't buy the full suite. Oracle is well managed. But I don't see how they grow the company much more than modestly. Why is that worth a 15 multiple?

Wick: IBM is shrinking and trades for 15 times cash flow.

I've given you four picks and have two pans. The first is Snap [SNAP]. It went public last March. The stock is below the IPO [initial public offering] price, but could sink further. Advertiser feedback isn't all that encouraging. A lot of advertisers have tried using Snap and have found it a poor return on investment. The demographic is limited, so potential advertisers can't advertise high-ticket items like cars, mortgages, or real estate. Even liquor is off-limits. The product is faddish. There has been lots of executive churn. They've lost significant share from Facebook's [FB] Instagram Stories.

How do the numbers look?

Wick: The financials are dreadful. The company has an enterprise value of about $15 billion on projected revenues of about $1.1 billion, and they are burning $700 million to $800 million a year of cash. There is a large lockup agreement expiring on March 2 [certain insiders will be able to sell shares after that], the one-year anniversary of the IPO. Snap had raised $1.8 billion from hedge funds, venture-capital funds, and mutual funds a few years ago. In five years, we

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- Paul Wick: How to Play the Big Trends in Tech

believe, Snap could be like Palm or AOL Instant Messenger—kind of a footnote—or just disappear.

Barron's recently wrote a negative piece about Intrexon [XON]. It operates similarly to a biotech holding company; it is a rollup of struggling biotech companies and assets. Intrexon has ownership stakes in other small, struggling public companies, typically via another firm run by the CEO.

What sorts of companies are they?

Wick: They have genetically modified apple business; the apples, they say, don't turn brown when cut. As for revenue, they say "we're still planting trees so you have to wait three to five years," until they mature. Then they have a genetically modified mosquito business to counter the Zika virus. No one has employed it on a meaningful commercial scale. They have a biofuels division; a few years ago, they were talking about a huge contract partnership with a large energy company, Dominion Resources. A year after Dominion backed out, they don't talk about this business anymore. A big chunk of revenue—the market cap is $1.7 billion, annual revenue is $200 million—comes from cattle-breeding services. This is a strange company.

What keeps the stock aloft?

Wick: People get excited. The CEO made an announcement a number of years ago about licensing something from the M.D. Anderson Cancer Center, and we have seen nothing ever come of it. The CEO put out a letter on Jan. 2 grading the company. He mentioned the stock market was giving it an F, but he gave it an A.

You have also been skeptical of Tesla [TSLA]. Any quick thoughts?

Wick: I'm still skeptical of Tesla. The company keeps missing numbers. I suspect the Model 3 will be a disappointment, and there is tons of competition. If the company is successful this year, it is going to run through the $7,500-per-car tax credit for purchasers because it will have used up its allotment at the same time that competitors such as Jaguar are coming out with electric vehicles and will make full use of it. Tesla is disadvantaged. I am mystified as to why the company hasn't raised money with the stock price north of $300. That would be the smart thing to do.

Thank you, Paul.

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