MarketWatch

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Stupid Investment of the Week

Commentary: On its face, and elsewhere, Red Hat falls flat

By Chuck Jaffe, MarketWatch

BOSTON (MarketWatch) -- The stock market's rally over the last few months has emboldened some investors to climb aboard the hottest sectors. Unfortunately, many stocks that have given a good ride now threaten to come to a screeching halt.

So while the headlines say that a sector like technology is gaining steam, certain stocks in that niche are laying a trap for average investors -- folks who will buy high now and sell low later.

One security that appears to be creating such a trap is Red Hat Inc., the North Carolina-based firm that distributes and supports open-source operating systems. Up about 55% thus far into 2009, the stock has reached a point where there may be more danger than promise ahead -- the point where it has become the Stupid Investment of the Week.

Stupid Investment of the Week showcases the concerns and characteristics that make a security less than ideal for the average investor, and is written in the hope that spotlighting the worry points in one case will make it easier for consumers to sidestep danger elsewhere. While obviously not a purchase recommendation, neither is this column intended as an automatic sell signal, as unloading a worrisome investment can sometimes compound problems.

WSJ Adviser: The Web is Dead says Altucher

Columnist and portfolio manager James Altucher explains to Simon Constable why Google, Facebook and other internet plays are dead from an investment standpoint. Plus what stocks are hot in the rest of the economy.

Seeing red

For investors in Red Hat, there are capital gains to worry about for short-term holders, as well as those who first bought into the company around 2005, when the stock had a triple-digit bounce-back from the post-Internet bubble bear market.

Right now, the case for buying Red Hat is compelling -- I may be sounding the alarm a bit early on this one, as its run is not showing signs of slowing -- but it's much closer to recent peaks and the volatility of the issue highlights the danger for average investors.

Red Hat is unusual in the tech world, because it has managed to make money by giving away free software. Open-source software is free for anyone to use, distribute and modify, which has the potential to make it hard to keep customers, because those clients have a right to use Red Hat software even if they switch to a different support provider.

That has tended to hold down the company's profit margins, which are about half the size of firms selling proprietary software (think Oracle here). It also reduces what any acquirer might pay for Red Hat; while the company has been an almost-constant part of the merger rumor mill, the fact is that any buyer can already take Red Hat's technology for free. Even if the client list and product certifications are worth buying -- and they might be -- it's hard to envision getting a significant premium for the shares.

Then again, the shares appear to be trading at a premium now, and that is arguably the biggest part of Red Hat's current position.

The stock hit its 52-week low of $7.50 in November (also its low over the last five years), and has had an almost straight-line gain since then, to where it now stands north of $20 per share. If you are a growth investor or a momentum buyer, you're convinced; in fact, Value Line gives Red Hat its best score for "timeliness," meaning the firm expects the stock to continue its outperformance for the next six to 12 months.

But if you factor value into the mix, you see the storm clouds mounting.

"You start paying too much for earnings if you buy when the stock has already risen," said Brent Wilsey of Wilsey Asset Management in San Diego, Calif.

Investment researcher Morningstar Inc. puts RHT's fair-value at $14 per share. If the rally ends and the stock falls to that level, investors would take a 30%-plus haircut.

Added Gregg Brewer, executive director of research for Value Line: "With a [price/earnings ratio] up in the 50s, there isn't a lot of room for error. With such high investor expectations, if something should go worse than the market expects, a quick sell-off would be likely."

Valuation questions

And David Trainer, president of New Constructs, a Nashville-based independent research firm, takes it much further. He said investors have a reason to expect something to "go worse" with Red Hat.

New Constructs currently has RHT on its monthly list of "most dangerous stocks," on the basis of profitability, earnings and valuation that Trainer considers to be out of whack. New Constructs sifts through balance sheets, looking at footnotes and other items to determine true economic earnings.

Trainer said that while the financials show historical profits, Red Hat has "never been profitable from a cash economic perspective."

He added: "The company is reporting that net income is positive and rising while the actual economic earnings are negative and declining at five times the pace the company is reporting net income growth."

That leads to the big valuation issue. According to Trainer, "the current stock price implies RHT will grow revenues at 30% compounded annually for each of the next 10 years. ... This is organic growth, no acquisitions assumed. Free cash flow would have to grow at 35% compounded annually for 10 years in a row. Has any company ever done that? I doubt many have."

And in what many have called a traders' rally -- where leading stocks haven't necessarily had the strongest financials -- there's always the worry of how much a change in the tides can hurt. With RHT trading at more than twice the market's P/E ratio, you have to be concerned that the stock will take a dunking if the tide were to run against it.

Said Wilsey: "The numbers say Red Hat is way too expensive, that you are paying way too much right now. That doesn't mean it's going to drop like a stone -- in fact, someone selling now could be getting out early -- but it means that there are companies out there that are good buys in this market, that are priced reasonably and have solid growth potential. Right now, Red Hat isn't one of them."