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Stupid Investment of the Week

The bloom may come off this rosy stock faster than investors realize

By Chuck Jaffe, MarketWatch
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BOSTON (MarketWatch) -- Did you spend too much money on Valentine's Day? It's a day that serves as an annual reminder that love sometimes makes us crazy enough to overpay.

But when the object of your affection is a stock, there's a steep price for paying too much; like Valentine's Day goodies purchased on credit cards, everything seems fine at first blush, and it's only when the bill comes due that investors get that sick feeling.

One stock that investors seem to love to the point of excess is MEMC Electronic Materials, which has gained altitude like a rocket ship on takeoff over the last three years, but which now is poised for a downfall so big that it's fodder for Stupid Investment of the Week.

Stupid Investment of the Week showcases the characteristics and conditions that make a security less than ideal for the average investor, and is written in the hope that spotlighting danger zones in one issue will make those problems easier to root out elsewhere. While obviously not a purchase recommendation, neither should this column be interpreted as an automatic sell signal; sometimes, unloading a problem investment unleashes a new set of consequences.

For long-time holders in MEMC Electronic Materials (WFR) , the big concern would be capital gains, as the stock gained 67% in 2005, 76% a year later and then topped both years with a 126% gain in 2007.

There have been some very good reasons for those gains. MEMC makes raw silicon wafers, the base building blocks for the production of semiconductor chips. There are few companies in the business, and MEMC is one of the largest; moreover, the supply of wafers has been thin, and demand is strong, which is the basic recipe for increased profits.

Dig into the financials and it's hard to believe the company was on the verge of bankruptcy in 2001. The balance sheet has been transformed into the picture of health, so that the company now has $1.3 billion in cash and investments against just $816 million in total liabilities. That cash is being poured into a massive share-buyback plan.

Morningstar Inc., the Chicago-based independent research firm, gives MEMC grades of A or A+ for growth, profitability and financial health. Zacks Investment Research, another Chicago firm, has a buy on the stock and a six-month target price of $105 per share, which would be a 30% gain from current levels. Sabrient Systems, an independent research firm based in Santa Barbara, Calif., also has a buy on the stock -- meaning it expects continued out-performance for the next six months -- thanks largely to an "outstanding growth profile."

In short, it's the kind of stock that is easy to fall in love with. That's precisely why it appears that current buyers are overpaying.

Look out below?

The cyclical nature of the wafer business is hard to dispute; the business goes through periods of tremendous expansion and contraction, based on product-development cycles that change the size of the wafers being used on the most popular products. While MEMC may be able to use solid growth opportunities in the solar panel business to offset some of the trend when it turns, it can't control the pricing environment. Increasingly, wafers are a commodity, which means that the more competitive the business becomes, the greater the erosion of profit margins.

One fund manager, who asked not to be named because some of his colleagues own the stock, noted that whenever he sees a stock trading at just under 10 times sales and 20 times cash flow -- roughly the current levels on WFR shares -- he's thinking "Look out below."

He's not alone.

While Morningstar's grading systems love the stock, its analysts don't. Analyst Matthew Coffina recently pegged the company as one of the "most overvalued" issues on the market, suggesting the stock will come back to its fair value -- $25 per share -- by January 2010. That's not a trim; it's an amputation. Even if there is room to grow on the short term, the average investor seeing that kind of long-range danger needs to be concerned.

David Trainer, president of New Constructs, an independent research firm in Nashville, Tenn., said that according to his firm's discounted cash-flow model, MEMC Electronic Materials "must grow revenues by 30% and after-tax profits by over 25% every year for the next 10 years to justify its current valuation."

"I am not sure if any public company in the history of the world has done that," Trainer said.

With opinion standing so divided on the stock, an investor jumping in now has to decide just how confident they can be about those upside projections, and their ability to capture that growth before the wafer market turns and the giveback happens.

From the standpoint of Stupid Investment of the Week, where one regular target is having a stock drop 20% to 25% before it has gained 15% on the upside, there is little doubt that this call is risky, and possibly early.

From the standpoint of an average investor, the question is whether they can catch a rocket by the nose, without missing and getting burned. It's a high-risk decision, where the stock's volatility will make the typical investor particularly nervous.

MEMC is a company that has a lot to love, but overpaying to justify that affection is a bit like throwing too much money into Valentine's Day flowers. The short-term results may be beautiful, but you know the bloom will soon be off the rose.

Chuck Jaffe is a senior MarketWatch columnist. His work appears in dozens of U.S. newspapers.

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