MarketWatch

CHUCK JAFFE

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Stupid Investment of the Week

Commentary: This tech stock is a case of 'good company, bad stock'

By Chuck Jaffe, MarketWatch

BOSTON (MarketWatch) -- Swimming against the tide can be a difficult, hard-to-stomach tactic in the stock market. But when the tide is running hard and fast, the key to choosing stocks is determining which issues are due for a fall the next time there's a shift in the current.

Technology stocks have been among the market's stronger sectors since March 9, driving the Nasdaq past 2,000 on July 30 for the first time in nine months. But many of the sector's leaders have been stocks with questionable fundamentals and, due to the recovery, inflated valuations.

If and when anything makes tech stocks turn sluggish, the ones who lack a distinct competitive edge and solid underpinnings are likely to turn around quickly. So an investor feeling bullish enough to be in tech stocks now needs to carefully weed out the ones that will be unable to fight the turnaround tide when it comes.

One stock that seems poised for that kind of unfortunate turn is SanDisk , today's pick for Stupid Investment of the Week. Stupid Investment of the Week highlights the concerns and conditions that make a security less than ideal for the average investor; it is written in the hope that spotlighting trouble in one case will make it easier for readers to root out danger elsewhere. The column is not intended as an automatic sell recommendation.

Will the market's positive vibe last?

WSJ's Money & Investing editor Ken Brown tells colleague Dennis Berman second-quarter earnings has added to risk appetite and an overall positive vibe in the market. Still, it's not all rosy, he says. (Aug. 5)

SanDisk -- one of the leading producers of flash-memory products for use in mobile phones, portable computer devices, digital cameras and more -- has supporters who can argue that the company has never had more going for it than it does right now. In late July, the company surprised analysts by announcing an unexpected profit of $68 million for the third quarter of its fiscal year, compared to a loss of $165 million in the first three months of this year. Revenues of $731 million for the quarter represented sequential sales growth of 11%.

Best of all, the flash memory business -- one of the toughest tech sub-groups in which to gain a competitive stronghold so price competition is always brutal -- wound up with improved pricing, a combination of production cutbacks throughout the industry coupled with increased demand due to all of the new electronic doo-dads that need flash storage. SanDisk significantly reduced its production costs.

That said, the good news was tempered by the company's announcement that summertime sales could decline by 1% year over year; that puts them ahead of the pace of the most recent quarter, but it's still a setback in the eyes of most analysts. Further, officials said they expect that flash memory prices will do no better than hold their current ground and may give something back over the rest of 2009.

Supply to meet demand

Expect the flash memory companies -- including SanDisk, Micron Technologies and Samsung Electronics, among others -- to shoot themselves in the foot here; they're increasing production due to the heightened demand reported over the second quarter, which will turn the supply-demand balance on its ear, raising the supply, cutting prices and hurting SanDisk and its competition along the way. Part of the problem is that flash memories are something of a commodity, where price determines the purchase more than technological leadership; SanDisk technology may be on the cutting edge, but it might not be enough to stave off any downturn the industry sees going forward.

Looking at the firm's fundamentals, you have to expect the operating profits to disappear; an operating loss for the current fiscal year would be no big surprise, despite the positives of the most recent quarter. The company's history of losses isn't wiped out by the one quarter of good results.

The question for investors is whether that little bounce changes their long-term perception of the stock.

It shouldn't.

While sales were up quarter-over-quarter, the current numbers still represent a long-term decline on a year-over-year basis, a trend that will not be changed or helped by the industry's pricing situation. SanDisk has average financial footing, with $1.6 billion in cash and short-term investments against $1.2 billion in short-term debt.

Lifted by a rising tide

In short, it's a good company that may currently be a bad stock, based largely on its valuation. The rising tide has lifted SanDisk from $7.65 on March 9 to well over double that price today; a good buy back then, the 130% gain brings its current price into question.

Morningstar Inc., for example, pegs its fair-value estimate on the stock at $18 per share, which is roughly where it's trading now. Zacks.com has a six-month price target of $10 on SNDK shares, good for a sell rating. David Brown of Sabrient Systems said the stock's valuation is too high, making it a sell that's on the verge of moving into "strong sell territory."

Ultimately, SanDisk falls into the category of "good company, bad stock," one where the market rise has raised optimism out of line with long-term realities that will eventually be factored back into the share price.

"To justify the current price, [SanDisk] has to grow revenues at 15% compounded annually for each of the next 15 years, all the while improving its return on invested
capital (ROIC) from -25% -- the level at the end of the last fiscal year -- to 10% within 15 years," said David Trainer of New Constructs, a Nashville-based research and analysis firm that has pegged SanDisk with the label of "dangerous stock."

"That kind of growth is a difficult hurdle to clear on its own, as is that kind of improvement in profitability," Trainer added. "Together, they represent an even more formidable hurdle. Accordingly, we think the stock's valuation is too rich, leaving investors with more downside risk than upside potential."

That's the definition of a stock that can surf with the tide, only to get dragged back out to deep water if anything makes the broader market shift.