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THE TRADER

# Stocks Fall Slightly After a Jittery Friday

*Valuation concerns returned amid fears over Putin's Ukraine intentions. Some investors pared holdings ahead of a possibly volatile weekend.*

By [VITO J. RACANELLI](#)

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## [Vital Signs](#)

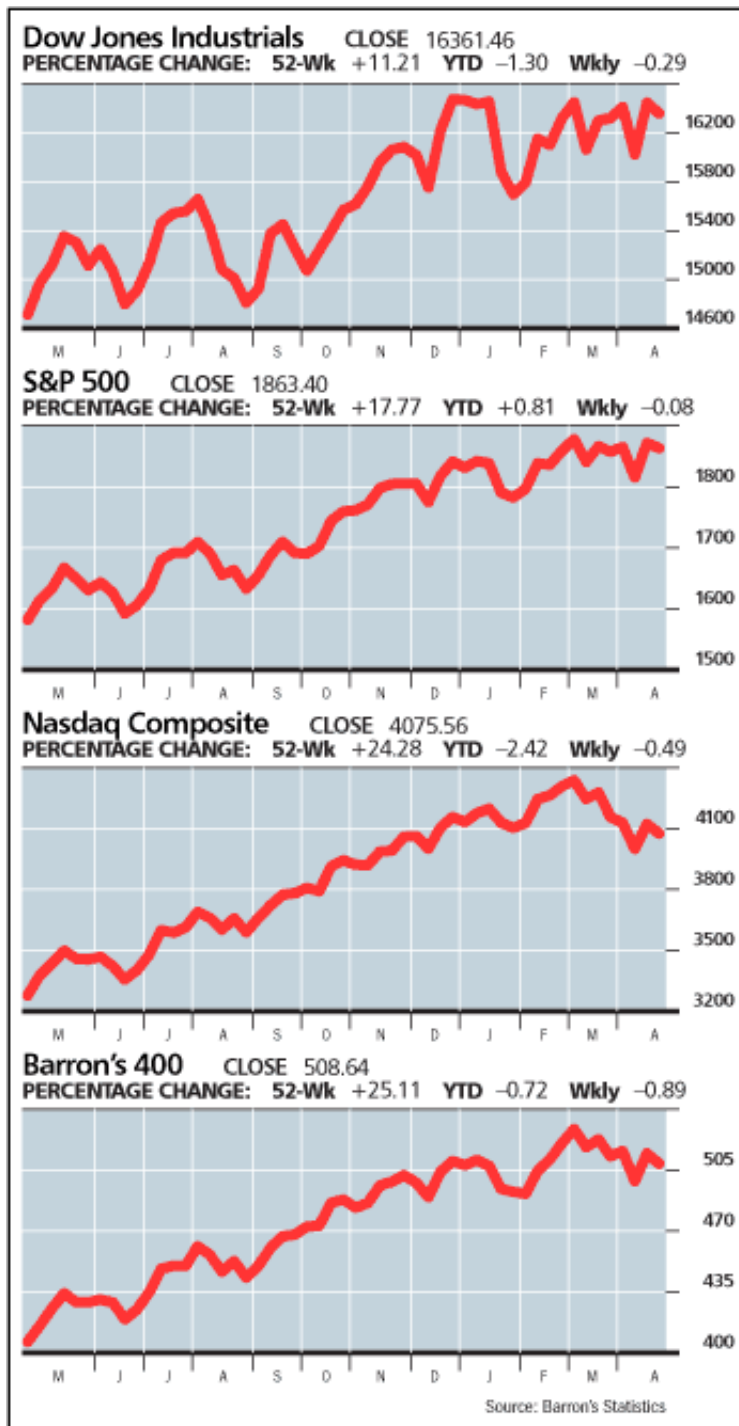
A bad Friday ruined what had been shaping up to be a good week for stocks. By week's end, the broad indexes finished slightly to the downside after being ahead more than 1% at one point Thursday. Technology stocks were whacked hard.

First-quarter earnings releases last week were mixed to good, but the valuation concerns that have intermittently gripped the market in recent months returned Friday. Layered over that were heightened geopolitical tensions in Ukraine, which made many investors unwilling to risk holding equity, particularly those highly valued social-media stocks, while markets were closed.

Some people anticipate that Russian President Vladimir Putin "isn't done" in Ukraine, so many investors decided to take some money off the table ahead of an entire weekend of potentially worsening conflict, says Doreen Mogavero, CEO of broker-dealer Mogavero.

On the week, the Dow Jones Industrial Average lost 0.3%, or 47 points, to 16,361.46. The Standard & Poor's 500 index gave up less than two points, or 0.1% to 1863.40. The Nasdaq Composite index, however, fell 20 points, or 0.5%, to 4075.56.

Twice last week the S&P 500 index approached the previous record high of 1890.90, set April 2, and wasn't able to punch through. That follows similar failures to follow through earlier this month, so "the market's looking tired," says Christopher Zook, chief investment officer of CAZ Investments. "It's not a good sign" that the utilities sector, up 13% this year, is by far the best acting group in the market and the consumer discretionary sector the worst, he says. "The leadership is shifting and the market needs to correct," he adds.



The market appears to be hesitating around 1880 on the S&P 500 index, adds Yousef Abbasi, a market strategist for Jones Trading Institutional Services.

In some cases, strong earnings weren't enough to stave off stock losses, he notes. Visa (ticker: V) reported quarterly profits that rose 26%, but its stock fell 5%. In particular, he adds, many investors remain concerned about the valuation issues that have hurt the highly valued tech and social-media stocks. Facebook (FB), he points out, released strong quarterly earnings last week, yet the stock fell 6%.

Next week sees some potentially market-moving news, including a Federal Open Market Committee meeting Tuesday and Wednesday; the official estimate of first-quarter domestic product growth on Wednesday, where expectations are for a 1% rise; and April nonfarm payrolls Friday, with economists expecting a 215,000 rise.

### *Valuing LinkedIn*

After the recent selloff in social-media stocks, sky-high valuations have fallen for many. That doesn't mean they're cheap.

At \$158.17, shares of LinkedIn (ticker: LNKD), the professional-networking

Website, are down 37% from highs. Though it fell 10% last week, it is well liked by investors, with no Sell ratings from Wall Street brokers. Yet the shares remain overvalued by conventional measures, which bulls eschew for the company's own adjusted results.

For example, in addition to results based on Generally Accepted Accounting Principles, the firm likes to present its adjusted earnings before interest, taxes, depreciation, and amortization (Ebitda). This is a non-GAAP figure that leaves out stock-based compensation—which is common among tech companies—among other items.

In 2013, net revenue grew 57% to \$1.5 billion. Adjusted Ebitda soared 69% to \$376 million and non-

GAAP net income rose to \$192 million, or \$1.61 per share, from \$100 million, or 89 cents, in 2012. That seems good but leaves out a hefty \$194 million in stock-based compensation. LinkedIn is guiding for a 2014 adjusted Ebitda of \$490 million, 30% higher. Yet the adjusted Ebitda growth rate is down by half, and that leaves out an even bigger \$325 million in estimated stock compensation this year.

Using consensus estimates for LinkedIn's adjusted non-GAAP 2014 EPS of \$1.57 results in a still high price/earnings ratio of 100 times. That's three times the growth rate, which happens to be slowing sharply from 2013. It's difficult now to see LinkedIn as a super-growth story and deserving of a triple-digit P/E multiple, even based on more-flattering adjusted figures.

Though not paid out as a cash expense, stock compensation needs to be taken into account in the multiple. When it is, the picture appears much less attractive. LinkedIn's 2013 GAAP net income was \$27 million, or 23 cents per share, up 21% from \$22 million, or 19 cents per share, in 2012. The trailing P/E is 687 times. Taxes fell sharply but had they been similar to 2012's level, GAAP net income would have fallen last year.

Moreover, LinkedIn's costs are rising as fast as its revenue, faster in the case of general and administrative costs, up 76% in 2013 versus a 71% rise in 2012. LinkedIn's net-income margin was 2% last year, roughly what's seen at a supermarket.

LinkedIn's valuation embeds significant future profit growth, so slowing growth should be of great concern to investors, says David Trainer, president of New Constructs, a Brentwood, Tenn.-based independent research outfit. The company hasn't been able to translate its revenue growth into strong profit growth, and return on invested capital was cut in half last year, to 4% from 8%, adds Trainer, who is short the stock.

He points out that many LinkedIn metrics, though at high levels absolutely, are going the wrong way. Growth in revenue, membership, unique visitors, and page views is slowing, notably so in some cases. (See table.) Even the adjusted consensus 2014 EPS estimate has come down, now \$1.55, versus \$2.22 earlier this year.

Let's compare LinkedIn with Facebook, which also uses GAAP and non-GAAP measures. Facebook saw 2013 revenue grow 55%, about the same as LinkedIn. But the Menlo Park, Calif.-based social-media company raised GAAP earnings sharply to \$1.5 billion, or 60 cents, from \$53 million, or one cent.

Facebook has much higher margins and sports faster-growing GAAP and non-GAAP net income, but it trades at significantly lower valuations: a P/E of 54 times 2014 GAAP EPS consensus of \$1.06 and 41 times expectations of \$1.41 in adjusted non-GAAP EPS, which also excludes compensation.

LinkedIn didn't respond to a request for comment. Its growth rate is at a level that most companies could only wish for. Unfortunately, the high stock valuation discounts growth accelerating even as it's decelerating.

### *Zoetis' Steady Virtues*

## Growth Slows

While LinkedIn's annual growth rate might be the envy of many firms, it's slowing significantly and isn't reflected in the stock price.

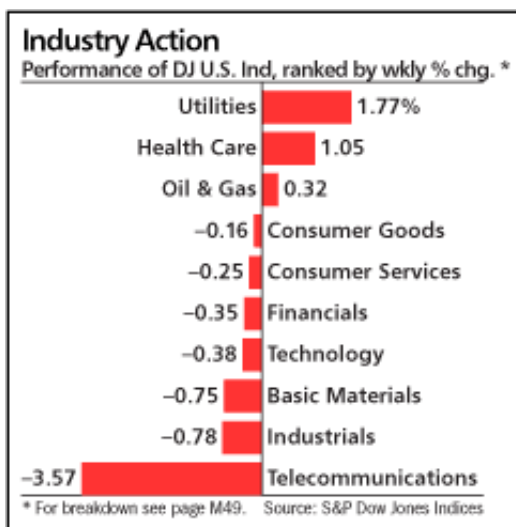


One stock without a triple digit P/E is animal-health firm Zoetis (ZTS). Now that its stock is down about 15% from highs, on mostly one-time issues, it's worth a look, particularly for a portfolio holding lots of highly valued tech stocks.

On Feb. 11, Zoetis, a global producer of animal vaccines and medicine, topped fourth-quarter 2013 expectations and noted the quarter's 7% revenue rise would have been 9% but for negative currency effects.

That issue has bled into the new year and management guided analyst estimates for 2014 down, forecasting 2014 "adjusted" EPS at \$1.48 to \$1.54 and revenue of \$4.65 billion to \$4.75 billion, below previous analyst expectations of about \$1.62 and

\$4.77 billion, respectively. Zoetis' non-GAAP adjusted results exclude traditional nonrecurring items such as acquisition costs, restructuring charges, and initial public offering expenses, but not stock compensation. (Zoetis was spun off from Pfizer (PFE) last year.)



The roughly 10 cents per-share guidance shortfall has hurt the stock and was due to both operational and nonoperational issues, notes Craig Giventer, a money manager with Financial Partners Capital Management, which held Zoetis stock before the results were announced and has added shares since.

About five cents derives from foreign exchange, he says, and the rest from pork and cattle life-cycle issues, among other things. For example, the U.S. pig population has been hit hard by the porcine epidemic diarrhea virus, which killed more than 4 million piglets over the past year.

These are generally short-term industry issues and aren't nearly as important as the beneficial long-term trends for animal health and medicines, Giventer adds. There is an emerging global middle class with a diet moving more toward protein and the consumption of meat. Getting medicine to market in animal health is much more straightforward than the human-drug approval process, and there are no intermediaries like pharmacy-benefit managers to worry about.

The money manager calls Zoetis' steady and stable 5% to 6% long-term secular sales growth and 10% EPS gains a "good story in today's market." He believes that as the newly independent company gets its legs it should be able to expand operating margins to about 30% from 25% over the next five years.

The stock trades at about 20 times this year's EPS guidance. But investors don't have to rely on analyst estimates because Eli Lilly just did the math. Last week, Lilly agreed to acquire Novartis' (NVS) animal-health division for about \$5.4 billion. That deal values the Novartis division at about 4.3 times sales or a 25-to-30 P/E. The same ratios applied to Zoetis result in a \$35 to \$40 price, 15% to 30% higher than Friday's close of \$30.16.

Zoetis offers a solid business with pricing power and good financial characteristics, and one that's not an Internet business.

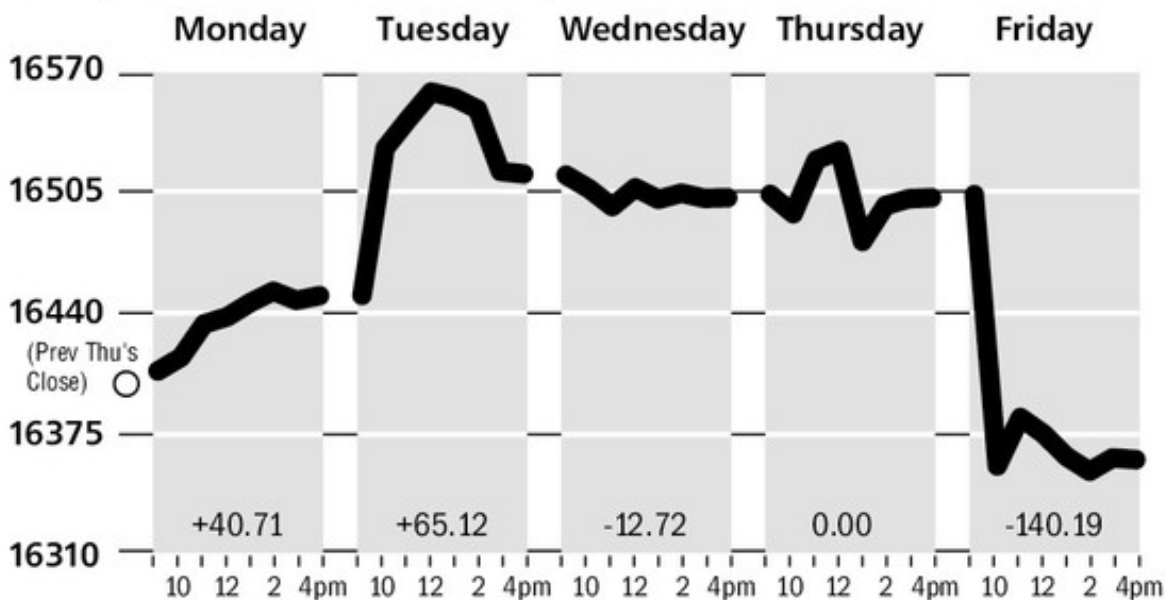
### Looking Good With Allergan

This column normally reviews its picks at year end. Occasionally, a spectacularly bad or—happily, in this case—good pick must be acknowledged, if only to close out the position.

In December, we suggested Allergan (AGN), a specialty health-care maker of Botox, was cheap at \$98.20. Last week, Valeant Pharmaceuticals International (VRX) and activist investor William Ackman offered to buy Allergan in a deal that could be worth about \$159 per share. Investors might consider selling Allergan now for a 70% gain, instead of waiting for a higher bid or the deal's conclusion.

## FIVE-DAY DOW COMPOSITE

**Valuation Blues:** Investors worried about social-media valuations bailed as the weekend arrived. The index fell nearly 1% Friday and 0.3% on the week; Visa and AT&T lost about 4%.



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