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MARKET INSIGHT

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The Stage May Be Set For a Tech Recovery

FIRST-QUARTER earnings from technology bellwethers like **Microsoft** and **Intel** have been strong. And so far this year, the Nasdaq composite index, which is heavily weighted toward technology, is up more than 6 percent.

Christian G. Koch, a managing director and senior technology analyst at Trustco Capital Management in Atlanta, talked last week about whether the sector had begun a sustainable recovery. Following are excerpts from the conversation:

Q. *Are fundamental conditions improving for technology companies?*

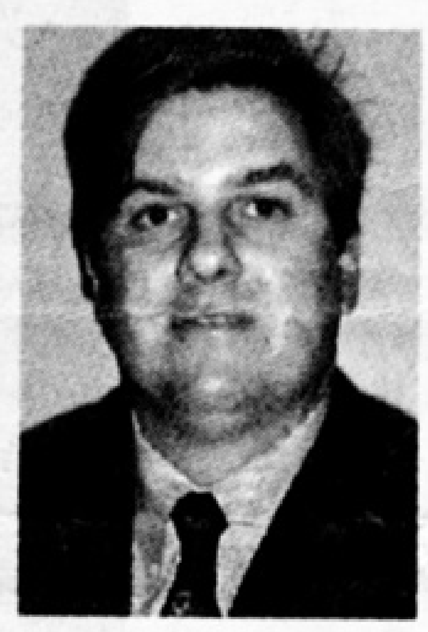
A. As of December, from a sales perspective, we had a low-trajectory recovery pattern in place. Sales were up 4 percent year over year.

I would argue the recovery is in place and there is a positive turn, but it appears there is a stall period that is happening right now, due to softness in demand for large-ticket technology products from early February through March and what historically has been a fairly slow seasonal period in the second quarter. But we are coming out of the soup.

Q. *Which technology subsectors do you favor?*

A. We have been adding to our software exposure because we believe expectation levels for revenue growth have been declining. Customers are pushing out orders. You can only go so long before you have to spend at a minimal rate again. Companies like **Oracle**, **BEA Systems** and **Mercury Interactive** will be set up for a nice recovery.

And we have taken the view that you want to own or maintain exposure to early cyclical semiconductor companies. Lead times are very low right now for these products. And the supply chain has basically reduced their inventory levels. With any incremental demand improvement, there should be a pretty precipitous bounce. I have never known a modest semiconductor cycle. The recovery both in revenue and earnings will be higher than anticipated, but Wall Street has underestimated the demand side of the equation. Two companies we own are **STMicroelectronics** and **Xilinx**.



Koch

Q. *What is the outlook for Intel, the biggest semiconductor company of them all?*

A. I think Wall Street estimates are too conservative for 2004 semiconductor earnings. Intel is a perfect example of that.

Intel has the potential for a big bounce, and we started to emphasize the company after they reported their first-quarter results. The company has spent $12 billion over the last two years to lower their cost structure in terms of cutting-edge process technology. All you need is a marginal positive change in sales, say 2 percent to 3 percent, to get a 6 percent to 7 percent change in earnings growth.

The consensus earnings estimate on Wall Street for Intel next year is 80 cents a share. We see earnings power of about $1 a share.

Q. *Are you concerned about the risks posed to semiconductor stocks by severe acute respiratory syndrome, or SARS?*

A. SARS is the fly in the ointment for the early-cycle semiconductor companies because the supply chain is very much tied to Taiwan, Korea and China.

At the least, I think it poses a large element of risk to the near-term investment thesis, because it could disrupt supply by a week or two, and possibly for an extended period.

Q. *Do you like any data-storage companies?*

A. One storage company we think has attractive earnings characteristics is **Network Appliance**. They just started a new product cycle two quarters ago, and have shown accelerating revenue growth and very stable margins, in the 60 percent range, over the last five quarters.

Q. *Does the telecommunications sector interest you?*

A. Telecommunications still has systemic problems.

We were at an optical fiber trade show a few weeks ago, and companies like **Corning** and **Ciena** said they still have excess capacity. We are three years into the downturn and we still have 50 percent overcapacity! I was surprised that more progress had not been made. Management teams are still in denial about the amount of time it will take to get this excess capacity out of the system. They have been unwilling to close plants that are basically nonperforming assets.

Q. *Do you expect to see more company takeovers?*

A. One of the major themes for 2004 and maybe the second half of 2003 is consolidation. Large companies will start to buy smaller companies to improve top-line trajectory. We have already started to see that trend, and it will continue. At these levels, prices are reasonable versus where they have been over the last three years. And companies with big cash positions, like **Cisco Systems**, Microsoft and **Dell Computer**, have a lot more freedom to enter new markets and augment revenue growth. □