the internet analyst℠

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Strong Buys

Valuations Altered, Strong Buys Upheld

By Paul DeMartino

The Internet Analyst℠ *combed through research submitted to the Multex.com database this week, looking for Strong Buys. This column is intended as a starting point for investment ideas in the Internet industry, not as an ending point. The opinions expressed in this column are those of the firms mentioned, and not necessarily those of the author, The Internet Analyst, or Multex.com. In order to be included in this column, a stock must receive a firm's highest rating, and the valuation methodology must be included in the report.*

FISERV (FISV): On June 12, Barrington Research Associates reiterated its 1-Buy rating on the shares of banking-technology company Fiserv. The report is a relatively simple valuation note. The firm's premise is that at mid-2001, stocks will price at a multiple of their 2002 earnings, rather than at 2001's. While keeping its projected price-to-earnings multiple constant at 38-times, it has now based its price target on its 2002 earnings estimate of $1.90 per share, rather than its 2001 estimate of $1.61. In short, it's raised its target price to $72 from $60. On June 12, FISV shares closed at $56.80. There were 323 downloads of research on Fiserv from the Multex.com database during the week of June 4 to 10, and 28 new reports contributed.

MERCURY INTERACTIVE (MERQ): CIBC World Markets updated its model for Mercury Interactive on June 12, while maintaining its Strong Buy rating. The adjustments were made to account for the announced acquisition of Freshwater Software, a privately held designer of Web-server maintenance software, as well as the lower-interest-rate environment. The firm raised its top-line projections while reducing interest income — the latter primarily affected by Mercury's cash payment for Freshwater. In all, CIBC cut its EPS projection for the company for 2001 to $0.90 from $0.95, and raised its 2001 estimate to $1.18 from $1.15. It also lowered its discounted-cash-flow-derived target price to $68 from $70. The shares closed at $65.05 on June 12. There were 707 reports accessed from the Multex.com database, and 54 new reports written, during the week of June 4 to 10.

FIRST DATA (FDC): On June 11, U.S. Bancorp Piper Jaffray reiterated its Strong Buy on the shares of First Data. The report follows an analyst's conference that the company held on June 8. The firm digests the key take-aways to a few points:

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The company is likely to make or slightly exceed its projected $0.59 EPS target for the second quarter of 2001.

Western Union is growing nicely, particularly the Payment Instruments division.

Financial processing (or check clearing, as it's also known) is still displaying 10% year-over-year growth.

Card Issuance (First Data's credit card account services division) is continuing its systemwide upgrade, which is expected to add meaningfully to results in 2003 or 2004.

Its eOne Global product, meant to innovate Internet payments, is strategically important but still small.

U.S. Bancorp is also rolling forward its 12-month price targets, and so has raised its bar for First Data to $78 from $72, which is based on a price-to-earnings ratio. FDC shares closed at $66.99 on June 12. There were 779 readers of FDC research during the week of June 4 to 10, and 79 new reports contributed.

Sell Report

Liberty Digital

How Much Is a Lottery Ticket Worth?

By Aram Fuchs

Since my last piece on Liberty Digital (LDIG), the stock is down by 29%. The shares closed at $5.67 on June 12. Its awful record of investing in public Internet securities has hurt it.

The Internet companies that it invested in reads like a who's who of failed dreams: iVillage (IVIL), priceline.com (PCLN), Kozmo.com and others. In fact, you could have made a pretty penny simply shorting any public company that Liberty Digital touched. Call it the "reverse" Midas touch. Anything Liberty Digital invested in turned into fool's gold.

But now things have changed. Since my last Sell Report, the market has finally realized that the management team of Liberty Digital does not have any skill in investing in Internet start-ups. Thus the stock is now valued based on its only two cash flow producing assets — its 50% stake in The Game Show Network and its 56% stake in DMX Music, which distributes commercial-free music across a wide variety of media platforms. For instance, Thomas Weisel Partners, in a report dated May 16, 2001, values the 50% of the Game Show Network at $275 million and the value of the company's DMX stake at $302.4 million. Its various other public and private assets are valued at $245.3 million, for a total of $822.7 million. Meanwhile, the market cap of Liberty Digital is at $959 million.

Yet Liberty Digital still owns the rights to 6mhz of digital spectrum within the entire plant of the AT&T (T) Broadband network, which, under conventional compression technologies, should equal to between 12 and 14 interactive channels. Thus, investors are essentially receiving the right that Liberty Digital has to 6mhz of AT&T broadband spectrum for only $136 million. Indeed, if the company drops down to its recent lows, you would be able to get that right for free.

But there is still a long walk to get to the Promised Land. Initially, the idea was to invest in Internet start-up companies that could help Liberty Digital exploit the spectrum in innovative ways. But now that those companies have shown that they have the staying power of a June bug, Liberty Digital is going to have to figure out another way to develop the programming.

Besides the creative issues, there are other things the company has to worry about:

- It's reliant on AT&T Broadband rolling out advanced, interactive cable services in a timely fashion. Given AT&T's shaky capital structure, the rollout of these services is very difficult to predict.
- The conventional advertising business is in a steep recession that usually leads advertisers to be more conservative with their purchases. This will hurt any sort of advertising that interactive channels will try to sell.

But all in all, I think it's clear that this asset will be worth a lot more than "next to nothing" (which is what Wall Street is valuing it at) in five years. I never play the lottery because I know that the net present value of the odds that I will win anything are always less than the $1 I would pay for the ticket. But, if someone gives me a ticket, why wouldn't I play? I'm taking Liberty Digital off the Sell Report focus list.

Aram Fuchs is the CEO of Fertilemind.net. At the time of publication he did not have any interest in the securities mentioned in this article. Aram Fuchs frequently buys and sells securities that are the subject of his/her articles, both before and after publication. The value of any particular securities discussed may change at any time and are always available for review in a wide variety of financial publications and web sites. Under no circumstances should any information discussed in this article be considered financial advice or a recommendation to buy or sell securities.

Upgrades & Downgrades

Yahoo! Moves Up to the Sidelines

By Shannon Swingle

YAHOO! (YHOO): S.G. Cowen Securities has moved its rating of Internet portal Yahoo! up to Neutral from Sell. In its June 4 report, the firm states that in its channel checks with advertisers and ad agencies, Internet ad budgets have stabilized. Cowen expects that Yahoo! will meet estimates of $167 million and EPS of $0.01 in the second quarter of 2001. In its channel checks, Cowen found that Yahoo! has been "actively reaching out to Madison Avenue like never before," and feedback has been very positive. However, despite the appearance that visibility is improving, the firm is staying on the sidelines, based on the stock's "rich" valuation and on its ability to meet, but not exceed, estimates. Cowen forecasts full fiscal year 2001 EPS of $0.05 and EPS of $0.20 in the following fiscal year. The shares closed at $17.86 on June 11. Research about YHOO was accessed 1310 times, and 64 new documents were added to the Multex.com database during the week of June 4 to 10.

CHEAP TICKETS (CTIX): On June 6, Legg Mason Wood Walker upgraded the shares of this online travel company to Strong Buy from Market Perform, based on its attractive valuation and potential catalysts. The firm cites five potential catalysts in the coming months: 1) an updated, fully functional Web site, offering e-ticketing; 2) a new deal with Delta Air Lines (DAL) to expand fares and destinations; 3) effective advertising and marketing; 4) a new market in the Tampa, Fla. region; and 5) the shares are trading at 22 times Legg Mason's 2001 EPS estimate of $0.57 and 18 times its 2002 EPS estimate of $0.69. Cheap Tickets also has $140 million in cash and is valued at $140 million by the market. The shares closed at $15.31 on June 11. Legg Mason's price target on Cheap Tickets is $18. Research about CTIX was accessed 102 times, and 11 new documents were added to the Multex.com database during the week of June 4 to 10.

KANA COMMUNICATIONS (KANA): On June 5, Adams, Harkness & Hill increased its rating on the shares of this enterprise relationship management software provider to Strong Buy from Buy. The basis for the upgrade is that the combination of Kana and Broadbase Software (BBSW) — the new entity will be called Kana Software — will result in a powerful competitor in the CRM industry (specifically to E.piphany (EPNY) and Siebel Systems (SEBL). The new entity, which was announced on April 9, 2001, will be able to offer Web-based contact-center management, Web site knowledge management, e-marketing and e-mail routing, among other things. Leading the charge will be Chuck Bay, CEO of Broadbase. He has experience in integrating acquisitions, and the firm believes that this experience will be beneficial when facing challenges associated with a merger of equals. (Shareholders of Broadbase will receive 1.05 shares of Kana for each share of Broadbase exchanged.) On top of the enhanced capabilities of the new company, Kana is trading at a significant discount to the larger CRM companies. Adams Harkness & Hill has set a $5 price target, which is based on a four times multiple of revenues of $210 million for calendar year 2002. For 2001, the firm expects the combined company to generate pro-forma revenues of $153 million, and $208 million in sales in 2002. It forecasts a pro-forma loss per share of $0.05 in 2002. The shares of Kana closed at $2.04 on June 11.

Executives Zero In

Loudcloud

Benjamin Horowitz

President and Chief Executive Office

Interviewed by George S. Mack

Building Web sites and maintaining large databases can be overwhelming for even the most highly developed and mature enterprise. But there really are true outsource companies that can dramatically improve quality and consistency. One such organization is Internet infrastructure services company Loudcloud (LDCL). The Silicon Valley-based company can provide a turnkey solution for serious companies that want a picture perfect Web presence. Loudcloud's proprietary Opsware software technology enables a large business to operate and scale to huge dimensions using automation that is less subject to human slip-up after a late night out. The company came public in early March of this year —; a time when very few other companies would even think of trying to raise money in the capital markets. But a big part of the allure is founder Marc Andreessen, the brain behind the Netscape browser and former partner of Jim Clark at Netscape Communications. On May 15, I spoke with Co-founder and Chief Executive Officer Ben Horowitz, who is also a Netscape alumnus.

[THE INTERNET ANALYST — GEORGE S. MACK] Now, just so I'll understand, tell me what you do and why a customer would be interested.

[BENJAMIN HOROWITZ] We offer outsourced Internet infrastructure for enterprise companies. People who want to do well on the Internet but don't want to build the kinds of infrastructure that AOL Time Warner (AOL), Amazon.com (AMZN) and Dell Computer (DELL) have built, can basically rent that kind of infrastructure from us on a monthly basis.

[GSM] This is a complete turnkey service, is that right?

[BH] Yes. We basically worry about running things, keeping them secure and making them scale. Our customers worry about building their applications. That makes it pretty simple.

[GSM] People have told me we're in an age of specialization. But you seem to be going in the opposite direction, doing everything with a lot of different gross margins.

[BH] I'd say that's not quite accurate. We don't build data centers, we don't build computers, and we don't build software. But those things are part of our offering. If you'd like to look at it like Dell, which is a pretty focused company, it doesn't make chips and operating systems but all that stuff is in its product. And Dell doesn't have eight different gross margins. It's got a gross margin on its own products, parts of which it's acquired from a variety of places. We're similar, because we have a lot of suppliers, but our offering is very focused.

[GSM] Why is there a need for another Internet infrastructure company?

[BH] It's really quite simple. The problem the customer faces is that even though it's pretty easy to get good data center space and bandwidth right now, what's missing is a company that knows software and is in the business of running it for you. Customers need a company with deep, deep expertise in technology to make the running of software efficient and effective. If you look at our company and the people here and the technology they've built, there's really no provider other than Loudcloud that knows software, which, interestingly, is where most everything breaks down.

[GSM] Nobody likes to see a slowdown in spending, but do you feel the outsourcing model has been helped, at least in the long run, by the slowdown in IT spending?

[BH] It does help the outsource model, because it makes people consider their costs. And because we're able to do things more cheaply than a company can do by itself, it makes the cost argument, which is a good part of our value proposition. The other two parts are quality and speed — we can get it all done better and faster. Before the slowdown, the cost part of the equation was a hard sell, because people had a lot of money. Now it's becoming a much easier sell. So that's been helpful, and I think it will be a long-lasting change. That will help the business over time — no doubt.

[GSM] Do you believe this information technology slowdown could actually usher in the outsourcing model?

[BH] Yes, it will. It will drive a lot of outsourcing. People are going to have to be focused. Smart companies will not spend resources on things that aren't strategic to their businesses. In particular, they won't spend their most strategic resource, which is their people, on things that aren't strategic to their business. Outsourcing does pick up a lot in a downturn.

[GSM] Back on May 2, you held a conference call and announced a cost-cutting program that would begin immediately, yet you did not guide analysts down on revenues. Nobody's going to quibble with prudence, but what made you decide to start this austerity program just two months after your March 8 IPO?

[BH] Well, we got some pretty interesting news on our IPO, if you'll recall. It wasn't atypical for the time, but it was definitely something we had to react to. It was that the price of the IPO was below the original filing price. The impact of that is that we raised less cash than we might have. And so we ended up with a funding gap. We believe, and I believe, that it's important to run the business in a way that is fully funded so we don't have to rely on the capital markets to sustain it. We must be able to generate our own cash flow. It was really an adjustment necessitated by the fact that we couldn't raise $200 million. It's one of those things where you'd rather have raised more money than have to skinny things up a bit. But it was the right move.

[GSM] It seemed to really shake out investors over a two-day period.

[BH] I think what happened was that any news at all right now — neutral or negative — is going to give investors the jitters. This was a relatively neutral announcement. That's just a sign of the times we're in.

[GSM] But you are a fully funded business model now, is that correct?

[BH] Yes. Most of the analysts who cover us have published that in their models.

[GSM] Almost a third of your customers were dot-coms. I've read that they were providing 23% to 25% or so of your revenue. Was this a conscious decision to bring these guys on as customers, or did they come to you, or what?

[BH] I believe that new companies will continue to have a significant impact on technology and on the Internet. They are good candidates to use our service, and in the early days of the company there were many of them. So just about everyone in our space signed up quite a few of them. And we'll continue to do so. There was a fairly spectacular shakeout of new companies in terms of all of them losing funding simultaneously, which is something that doesn't ordinarily happen. But if there's a good new company with good funding and it can pay its bills, would we sign it? Absolutely. We're not anti-new company by any means. I think the market has gotten a bit worse for new companies — it's harder to fund a new company today than it was 12 months ago.

[GSM] What was the percentage of revenue coming from dot-coms at the end of your fourth quarter (ended January)?

[BH] What we disclosed at the end of our January quarter was that 45% of our revenue came from enterprise customers, so the remainder were pure dot-com customers, as well as ASP [application service provider] customers. We didn't disclose the breakdown, but what we had disclosed previously was that for the second half of last year, a little more than 20% came from pure dot-coms.

[GSM] Is your dot-com exposure something you'd like to eliminate or reduce — not in numbers but on a percentage basis?

[BH] Yes. The plan is to reduce it a bit on a percentage basis. And that's a relatively easy thing to do, because the enterprise market is pretty good.

[GSM] You would obviously want to increase the percentage of enterprise names like some you already have — Nike (NKE), Fannie Mae (FNM) and Blockbuster (BBI). Without being too philosophical, what's your big selling point when talking to these kinds of customers? Is it service? Better software?

[BH] There are two things. One is that they can save money. The other thing, which is related to the first thing, is that they can consolidate their Internet efforts, thereby reducing costs while improving quality. For instance, with News Corporation (NWS), in the last five years it's built up a lot of different Internet businesses, and all of them have had their own infrastructures and cost structures. What we've enabled the company to do is have a single shared infrastructure for all of its Internet properties. News Corp. is able to save a tremendous amount of money and also have a more consistent quality, security and scaling, which are all the things you care about.

[GSM] We're now in your second quarter. Are you still on schedule to bring on some of the large enterprise customers you've been wooing, and could we see some of them announced this quarter?

[BH] Oh yes, definitely. I would say that our enterprise pipeline is probably better than it's ever been. There is certainly activity out there, and it certainly has something to do with the fact that we save them money. You'll hear some of those names this quarter.

[GSM] I think most people are aware that your founder and chairman is Marc Andreessen. Has his name been helpful in getting a foot in the door?

[BH] Well, it's more than his name. What Marc really brings, even more than his name, is himself. You might think that because he's famous people want to do business with Loudcloud, but most companies are a lot smarter than that. They don't want to do business with famous people, but they want to do business with people who want to help them succeed. That's what Marc brings more than anything else.

[GSM] But it doesn't hurt if Marc parachutes into a sales meeting, does it?

[BH] No, that doesn't hurt. It's very easy to get them to take a meeting with Marc.

[GSM] How big is your addressable market?

[BH] It's quite spectacular. Look at any serious business that's doing a substantial amount of revenue, and ask yourself if it's going to use the Internet for at least the software manifestation of that business. Well, it's going to be pretty significant whether it interacts with suppliers, customers or whatever. Obviously, it's going to want to use the Internet. But it's complex and difficult to run, and the technology is moving pretty fast. The question is, should the company be investing and doing it itself? The answer is, obviously, no. So any serious business is a potential customer for Loudcloud, and our average customer is spending about $100,000 per month with us. Do the math, and the market is definitely tens of billions of dollars in size.

[GSM] I've been thinking about the risk in your business. Zurich Scudder Investments and Thomas Weisel Partners had a joint venture that they decided to dissolve, and it was a customer of yours. Do you have recourse to recover that kind of loss?

[BH] When a company goes out of business like that, we can recover some of the future payments, particularly in a case like this where the parent companies still have money. But, in general, the way we handle that is that we have a very scalable infrastructure. So unlike a data center provider, which has built a building and has taken on a humongous amount of debt, we rent our infrastructure space, and we're able to skinny it down or build it out on a fairly short time horizon. If a lot of companies are becoming insolvent, we can scale back our infrastructure network.

Vital Statistics
Loudcloud (LDCL)

Market Cap:	$321.0 million
Shares Outstanding:	83.6 million
Recent Stock Price:	$3.84 (06/11/01)
52-Week Range:	$7.00 – $3.10
Price to Estimated (2002) Revenue:	4.3-times
Price to Estimated (2003) Revenue:	1.5-times

Years End In December	EPS	Revenue in millions
2001A:	($2.96)	$15.4
2002E:	($3.23)	$75.5
2003E:	($1.92)	$210.5

Source: Thomas Weisel Partners

Real Deal

Figuring the Market Is a Daunting Race

By Charles Payne

Usually when I evaluate a week I find myself discovering or pinpointing the silver lining by the actions that occurred during the latter half. However, I think the proper interpretation of the last few days of last week (June 4 to 8) could only be read as the glass being half empty. While the week itself wasn't high drama, each session was marked by an early tug-of-war. But the bears didn't put up much of a fight when the intensity level increased a notch or two. By the same token, the bulls seemed satisfied with small victories, perhaps because they knew that their troops were too exhausted to give an effort beyond those that resulted in the Nasdaq eking out a 3.05 gain for the week. (The S&P 500 was up .34, and the Dow ended the week 13.41 points lighter than it began.)

It was an interesting case, because the battle between the longs and shorts has been so intense this year, and yet there has been very little saber rattling of late. Whereas in previous weeks I would equate the action to gladiators doing battle, last week the best I could conjure up was an image of a few potbellied folks on the beach engaging in a game of tug-of-war. In fact, I think that the real battle for most investors took place in their minds.

The mental anguish of the market is the element that very few have ever mastered, and even those who do, only do so for a period of time. What brought down master investors like Julian Robertson and, to a lesser extent, George Soros was their inability to comprehend the mentality of the forces that dictated the market's actions between 1995 and 2000. Though few of us can understand the pressures of managing billions of dollars, we all live through a daily mental hell of trying to figure out the stock market — yes, even so-called long-term investors.

Of course, trying to figure out the mental aspect of the stock market and play it at the same time is a daunting task. Imagine jumping into the Indy 500 the day after receiving your learner's permit. The other drivers on the road just wouldn't care nor offer any assistance (at least not in New York). However, in this race something odd has happened. All the drivers have shifted down to first gear and don't appear to care if the pace car passes them by. The reason for this newfound caution is the ever-changing design of the track and the conditions of it surface. The market has never been a perfect oval, but it has its moments when visibility is great and the straightaways are long and smooth. Now the roads are marked with potholes and the scattered debris of crashes, and the turns are happening without any type of notice. Investors are moving at a crawl because they are operating under a permanent yellow flag.

When the market is moving fast, and preferably in an upward direction, the conscious mind takes a backseat to natural instincts — the ride is fun and exhilarating. The mental aspect of "thinking too much" actually becomes a roadblock to success. Such is the case now as we replay the facts, warnings and commentaries that hit us between the eyes on a minute-to-minute schedule. The "bad" news has become a part of the fabric of each session in the market. The more the race stalls, the faster the mind races. Let's face it, the stock market is a game that has no clock, so the intangible impact of the mind, thought and opinions has a way of discounting the fundamentals. The race never stops (unless there is a computer glitch), but when the mind is overloaded with confusion, the race can seem to spin its wheels.

The mental game will increase in intensity during the next few weeks, but investors have to deal with that and still be in position to hit the gas when the coast is clear. It's a dilemma and that can take a toll. The crowds have quieted down in anticipation of the next explosion as the players slowly make their way down the track of the unknown.

Warning, Warning…

My favorite robot of all-time is the "R-9" model from the cult-television classic "Lost In Space." His signature move was the arm-flailing, siren-ringing and light-popping motions that accompanied the call of "danger, Will Robinson," whenever he sensed a problem. He'd also become equally hysterical and would occasionally blare out "warning, warning, warning," to alert the crew on impending problems. It's a good thing the spaceship — Jupiter 2 — didn't make a crash landing on Wall Street last week, or that poor robot would have ended up in the repair shop. Corporate earnings warnings were as commonplace as the opening bell that begins the trading day at the NYSE. In fact, the warnings had a better track record of consistency. Barron's says that this quarter will see more than 1,000 earnings warnings from corporate America. This is just another record for corporate America and for those who set the expectations to be proud of.

What We've Got Here Is Failure to Communicate!

I've written in the past about how much credibility has been lost in the chain of communications that begins with corporate America, then to the Wall Street analyst and finally to the individual investor. (Of course, there's always a pit stop en route to inform the institutional investors of the goings on.) There has always been a problem with the message that investors receive from the Street, but now the source of confusion and mistrust begins at the root. There are many reasons for this, including the media glare that puts corporate chiefs in the hot seat. But one has to wonder why they can't get it right. The irony is that the biggest culprits of the earnings warnings are the tech issues — the very companies that sell hardware and software that allow for the second-to-second management of the industrial world.

I really can't figure out why these companies are so far off the mark. It would seem that there has to be some model that can take into account the momentum of the economy, the trends of the industry and the appetite of customers. Instead, it looks like these guys are taking a best guess and relying on accounting magic and a little luck to reach their objectives. While I'm sure Reg. FD plays a role, it can't be entirely to blame for the severity and consistency of the earnings warnings. With that as the backdrop, investors have been willing to overlook most of the warnings that have come their way. They do this by bringing the share price to a level that assumes there will be a warning. In other words, most of the underlying stock issues are already priced for disappointment.

Apparently, the worst-case scenario wasn't built into the share price of Juniper Networks (JNPR). Though the message boards were littered for months with rumors that the company would warn, the actual event caught many off guard. Even those who knew a warning was possible (including me) were shocked at the severity of the new guidance. Coming into the week, the Street was looking for EPS of $0.24 for the quarter; now analysts have been alerted to expect $0.08 to $0.09. As a result, the stock was slammed, dropping $8.61 and closing at $38.02 on June 8. Along the way, the stock crushed the Networking Index. But perhaps some companies are immune to the overall economic conditions.

I have been preaching for a very long time that the new guard should receive greater coverage by the financial media and a greater weighting in indices designed to reflect the real day-to-day results of the stock market. I feel that the over-reporting of the household names skewed the positive achievements of up-and-comers like Juniper and CIENA (CIEN). It's almost amusing that at the end of the week, comments from Intel (INTC) put the tech sector on a launching pad, coming into Friday's session, only to be toppled by the news from Juniper and others. Finally, the up-and-comers got the headlines, unfortunately for the wrong reasons.

So What Happens Now?

I keep looking back at last week and can't help but think that things could've been worse. There was absolutely nothing to celebrate. In addition to the earnings warnings, signs on the economic front continue to read "Caution," "Curves Ahead" and "Speed Bumps." Initial jobless claims were estimated at 416,000, with the actual number at 432,000. In addition, productivity decreased by 1.2%. This was far more than the estimate of 0.7%. It seems as if every day a new measure of the economy is coming in at record readings or being compared with totals not seen in years. Yet through it all, the market fought each day and had a head of steam going into Friday that could have resulted in triple-digit gains for the Nasdaq and the Dow.

Now investors have to, once again, play it close to the vest and know that warnings can stall or even derail the market. However, there is no doubt that stocks can and will trade higher when the coast is clear. Hopefully that will be soon, though next week is sure to have a surprise or two to greet us every morning or after each ringing of the closing bell. The trend has been for earnings warnings to come out in bunches immediately after the end of the quarter. That would suggest that after next week, the coast should be clear. As for the state of employment and productivity, I think the Street has mentally put those items and their consequences on the back burner. For now, it's just a matter of weathering the earnings storm.

The Week Ahead

Life is all about cycles, and the stock market is just a microcosm of life. Most of the people of the world believe death is an event that marks the end of one journey and the beginning of another. And so it is that the stock market is looking to begin life again. In fact, the biggest question going forward is what kind of market will emerge from the ashes of the go-go '90s. It's fair to say that there is a high level of anticipation and excitement about the emerging new market. Investors are pregnant with hopes that the next market will be healthy and strong. I'm not sure how long the gestation period will continue, but the best hunches think the birth of a new, better, smarter bull market can be counted in weeks not months.

Observations and Other Musings

Half the stocks on the NYSE didn't trade at the opening bell, and the sad part is most players didn't even know — or care.

Business 2.0 tried to change the standards of business periodicals and kill every tree in the country in the process. The new economy mouthpiece was the one pushing up daisies at the end of the day, effectively going out of business by selling to AOL Time Warner (AOL). The name will be kept, because of the recognition factor.

Speaking of branding and recognition, efforts at Net Zero (NZRO) have gone for naught. The company merged with hated rival Juno (JWEB) and renamed the new entity United Online.

The key market parameters remain 10,800 and 2200/2100 for the Dow and Nasdaq, respectively. Those numbers have been magic; let's see if they can weather another week of surprises and letdowns. I believe they will.

Venture Capital

Nature versus Nurture in the Investment World?

By Stephen DeNichilo

Life is like a game of cards. The hand that you are dealt represents determinism; the way you play it is free will.—Jawaharlal Nehru

Without thinking about it, clasp your hands together in front of you. Which thumb appears on top every time? Do you like chickpeas? When you walk into a room, does the party kick into high gear or how about when you step on a street curb, which foot always steps first, no matter what distance you are from the curb? Think about it. Are you predestined to hate lima beans or does your older brother condition you to hate them? The answers to these and various other questions are the center of an ongoing raging debate in the world of science called nature versus nurture.

Advocates of the nature theory attest that we are hardwired to act a certain way — to be shy, outgoing, honest, enjoy lima beans or hate Michael Bolton's music. Cases have been documented where separated identical twins reunited 40 years later only to discover that they are so similar it's eerie. According to theory, everyone has a unique genetic code that defines our person, no matter which direction our life turns.

Such definitive claims infuriate the nurture supporters. The nurture theory explains that while all individuals have basic inherent traits, our experiences, surroundings, childhood, parents and friends have a tremendous and lasting impact on our character. Many leading scientists believe we are products of our environment.

Where the heck am I going with this one? Isn't this a finance Web site?

Well, during a recent Italian summer barbecue with my family, (hoagies, sausage and canolis), this esoteric theory filtered throughout the conversation during lulls in the carnivorous feast, and inevitably caused deep self-reflection on the very basis of our souls. Simultaneously, as usual in this era, an ongoing discussion of the stock market was occurring, complete with the typical, "Damn AOL [AOL Time Warner (AOL)], damn Nasdaq, damn value stocks" commentary. Tired of questioning why I like macaroni salad over potato salad, or why I think golf is terribly boring television, I decided to meander over and unearth why I should damn AOL to Hell.

During this trite stock conversation where typical story lines were rehashed and cheeseburgers were eaten, a common theme surfaced: First, when were the Mets actually going to start winning, but the second comment went something like, "I don't need a broker. What do they know anyway?" Supposedly being the Stock Expert in the family (with the school loans to prove it), I am usually prodded to disperse some overwhelming wisdom about whether or not to utilize a broker or what is that next great stock pick. So with a full stomach, thoughts of my own existence, the floundering Mets, and that damn AOL churning in my head, I began to ponder the early 21st century financial markets and wonder why things are.

Have the rules been permanently breached? Is it time to stop reading about price/sales ratios and worry more about which company was last mentioned in Forbes as undervalued or which sector is receiving the most venture funding?

Can we actually apply the nature/nurture theory into the financial/venture capital marketplace?

Well, watch me try.

The Nature Viewpoint

A company is a company. A stock is a stock. If a corporation has solid earnings, strong genetic code (balance sheet, right?), and great growth rates — you'll win in the end. The long-term trend will always be up no matter what Greenspan does or where the Nasdaq will turn next. Invest in a sound business, and simply relax and watch your investment grow. The growth and success of your money is inherent in the company.

The Nurture Viewpoint

Who really cares what the company does anyway? What really matters is the current market environment. Greenspan's monthly comments and that lady's recommendation over at Goldman Sachs are far more important than a stock's growing losses. Timing is everything in investments — especially technical analysis. It is always time to buy or sell when a stock breaks its support or resistance levels. An investor must be cognizant of the market's attitude and act accordingly. All stocks adhere to the environment presenting them and one should closely evaluate companies in "hot" sectors.

In the last five years, with major indices rising consistently, the "wise" have certainly taken the nurture stance, pumping tiny companies into multi-billion dollar monsters. But is this really prudent?

For example, Commerce One (CMRC) is a leader in the B2B marketplace, providing global e-commerce solutions for business. Debuting in the summer of 1999, the stock exploded quickly to a market-cap in excess of $20 billion with first year revenue of about $12 million.

How ridiculous is that? Investors, blinded by growth rates and industry forecasts, grew this company's stock to the absolute limit. While the B2B marketplace continues to gain prominence, as companies develop "marketplaces" to efficiently pair buyers and sellers together, Commerce One was a bit overextended. Since the company's peak in the spring of 2000, the company's stock has retreated from a high of $165/share to around $6. Interestingly, the company is still worth about $1.2 billion, with revenues expected to come in about $180 million for the year.

Commerce One started to drop like a rock when the Nasdaq began to dive — critics surfaced, research analysts downgraded, and fundamentals were questioned. Unfortunately, the small guy got demolished, and was subject to the whims of the market waves. The environment (nurture) changed, and affected everyone's opinion of this once darling of the Nasdaq.

Maybe it's time to take a stand.

For what it's worth, my investing opinion (which uses both nature and nurture) can be explained using the simple metaphor of a tree — preferably a sturdy oak one.

I believe everyone should maintain a solid base of investments — established, profitable companies that have a tangible and popular product. This pool of investments represents the trunk of the tree and the nature outlook. Now, visualize our strong, proud tree, probably on top of a hill, silhouetted by the sunset, with fireflies dancing happily around, as crickets sound in the background — OK, I'm losing focus here.

Anyway, our investment oak tree has branches and leaves (bear with me here) that constantly sway back and forth with the wind; this represents our nurture outlook. A branch of a tree constantly conforms to its environment: it grows towards sunlight, sheds leaves in the winter, and sways with the wind. Our branches represent all our small, overvalued, crazy investments where a chance is taken on a high-growth, richly valued company — namely venture capital and other alternative investment vehicles that offer ample diversification.

The point is that it's OK to invest in "risky" private companies as long as an investor maintains a diversified portfolio with profitable, more mature companies. The fact of the matter is that the trunk of a tree holds it up, and not the branches and leaves.

Is it actually possible that nature and nurture can actually coexist in the investment world? Is it OK to think Pfizer (PFE) and Cisco (CSCO) are both good investments? I think so, and it is a much easier concept than trying to figure out why humans are the way we are: why some actually enjoy Michael Bolton's music or why others truly think golf is innovative television.

Analyst's Spotlight

Entrust

Bob Lam,
Analyst, Bear Stearns

Interviewed by Nate Hardcastle

The Internet Analyst[sm] spoke recently with Bob Lam, who follows network infrastructure firms for Bear Stearns. He has an Attractive rating on shares of Entrust (ENTU), which closed at $5.93 on June 11. Bear Stearns has performed underwriting for Entrust and makes a market in the company's stock. Mr. Lam does not own Entrust stock.

[THE INTERNET ANALYST — NATE HARDCASTLE] Entrust recently announced that it will close some offices and lay off almost a third of its work force. Why is the company restructuring?

[BOB LAM] Entrust has faced problems similar to those encountered by many other technology companies — specifically, the declining environment for technology spending. IT [information technology] customers' reluctance to invest in new products led to a disappointing operating loss in Entrust's first quarter.

Vital Statistics
Bob Lam, Analyst, Bear Stearns

Industry covered: Network infrastructure
Companies covered: Entrust (ENTU), VeriSign (VRSN), Internet Security Systems (ISSX), SonicWALL (SNWL), Micromuse (MUSE)

Now the company is making the moves necessary to produce earnings, and I expect them to work: Entrust should break even on cash earnings by the end of this year. It still had about $200 million in cash at the end of March and should have about $150 million, or $2.50 per share, at the end of the year. That cash hoard makes the stock pretty attractive at these levels.

[NH] The argument for investing in network security companies has been partly that demand should stay strong during an industry downturn because corporations will always need to buy security products. So why has demand waned?

[BL] Security is still a strong high-growth sector, but it's not immune to overall tech-spending downturns. In Entrust's case, its digital-certificate and online-authorization software require a lot of explaining to customers — and the customers, whose technology budgets have declined considerably, lately have been hesitant to listen to those explanations and then invest in new products. But the company's market still is expected to hit $3 billion by 2005; Entrust's revenues were $148 million last year, so it has a great opportunity for growth.

IPO Update

Goldman Sachs Analyst Barred from Kraft Road Show

By Jeffrey R. Hirschkorn

One of the more intriguing stories surrounding the pre-marketing launch of Kraft Foods' (proposed: KFT) $8 billion IPO happens to involve a rare research report issued by Goldman Sachs analyst Romitha Mally. It's certainly strange to see an analysis issued when a deal is in registration, but Goldman, according to public documents, is not involved as an underwriter in the IPO. Credit Suisse First Boston and Salomon Smith Barney are joint coordinators on the offering that is expected to begin trading in the middle of the upcoming week (June 11 to June 15).

"There's no doubt this [Kraft] issue will sell well because so many people who were burned in technology stocks now want defensive stocks for a more conservative posture," said Donald Yacktman, founder of The Yacktman Mutual Funds. "Few names of Kraft's size or prominence ever wind up coming to market."

Last week, a gathering of 500 attendees for Kraft's New York road show was limited to members of the underwriting syndicate and potential investors. Sources close to the initial public offering have informed us that they barred Ms. Mally from attending the presentation because of her rather unusual report on Kraft Foods, issued in April.

Escorted Out by Security?

Rumors circulated that the Goldman analyst tried to force her way into last Wednesday's road show, and sources inform me that she was escorted out by security guards. Reached at her offices on Friday, Ms. Mally, a well-known and highly respected food analyst at Goldman, categorically denied the rumor. "I didn't try to crash the road show, and I didn't get kicked out." She did indicate that she asked for an advance invitation to the road show, but her request was denied.

Sources told The Wall Street Reporter that Ms. Mally's report irked Kraft's underwriters and Philip Morris (MO), because she pegged "fair value" of Kraft's stock at $25, well below the pricing structure of the offering. In her report, she urged investors to be "aggressive buyers" up to $28 and to avoid the stock at more than $32. Over the weekend, Barron's Senior Editor Andrew Bary reported that "competitors privately accused Goldman of trying to sandbag the deal, although many institutional investors were happy to see the report because it offered a comprehensive look at the company and was more informative than the prospectus."

In her report, Ms. Mally concluded that a fair and just offering price would be at $25, far below the expected price talk of the deal. The latest revision pegs the offering to price at a range of $27 to $30. Previously, bankers planned to sell Kraft at $26 to $31, but they amended it to the current range a few weeks back.

Unwritten Code Violated

We previously indicated that all S-1, or registration statements, on file with the Securities and Exchange Commission don't include Goldman as an underwriter. One thing Ms. Mally failed to realize is that Goldman could be involved in the IPO in the underwriting group. That information wasn't available to the analyst at the time her report was issued, but officials at Goldman should have prevented that analysis from appearing if they intended to receive an allocation of shares on the deal. The timing of the research was viewed by the underwriters as unsporting.

Therefore, while Ms. Mally's report didn't violate any of the SEC's written protocols, it certainly broke unwritten code of providing pre-IPO analysis on any given company. Still, while her report created a sense of concern, one could also point out that unusual marketing efforts were orchestrated by Philip Morris to unload a small piece — only 2% of voting power — to the public.

Officials at co-lead underwriter Salomon Smith Barney told us late Friday that the tombstone-like ads appearing in many business-oriented publications were done without Salomon's involvement. In fact, we were told that all of the co-managers proceeded to place the aforementioned advertisements. Although many questioned the tactics by Philip Morris to create a friendly environment for Kraft's IPO, it apparently didn't violate any SEC regulations.

Increase in Deal Flow Can Easily Stop

While analysts have informed The Wall Street Reporter that we are definitely showing an improvement in deal flow, nothing is guaranteed. Most of the success is contingent upon the success of the Nasdaq Composite. The composite is improving after hitting its low in April. Although that may be true, this week's batch of initial public offerings isn't headed to the tech-friendly confines of the Nasdaq.

All of the pending transactions are scheduled for the New York Stock Exchange. This hasn't happened in an extremely long time and certainly proves the stability of the companies that are debuting in this market. Of course, the listing requirements are extremely strict for the Big Board, and profitability must be one of them because most of the week's candidates have real earnings.

"Earnings season is coming up, and if we have a lot of pre-warnings, that could drive it down again," said Michael Sarajian, vice president at Equilar, a San Carlos, Calif.-based IPO research firm.

Jeffrey R. Hirschkorn is Managing Editor of The Wall Street Reporter. Send comments to jeffh@wallstreetreporter.com.

Rants & Raves

Keep Your Eyes Glued to Stock Percentages

By K.C. Grainger, Grainger Beaulac Inc.

While I expect that the stock market still has upside left in the next several months, we should always be aware of the percentages that most of us never seem to focus on (and professional traders certainly do focus on those percentages). And since nobody owns "the market," but instead, on average, owns 10 to 15 individual stocks, we should focus on the percentage movement for the average stock rather than just the market.

If you take out a chart book or look at long-term charts, you will see that the average stock has a price variation of 30% to 40% per year. And recently, Nasdaq stocks have had an average annual price variation of more than 70%.

For instance, if a stock has a price of $15 and has traded between $10 and $20 during a 12-month period, off its bottom, it has doubled. That would be a 100% move or price variation. Few investors ever look at that. And they also assume that it's just the little stocks that do that. Not so.

Let's take a look at IBM (IBM). Between December 2000 and March 2001, it moved from the $80 level to $120. That's a 50% move. And from September 2000 to October 2000, it had a move down in price, from more than $130 to less than $90. It lost approximately 37% of its value. That's a major price variation for one of the largest companies in the world. And it's normal, not the exception to the rule. Traders and tremendous price volatility are two dominating factors that must be recognized and dealt with today. Huge percentage moves are the norm. So know and watch the percentages for your stocks.

As I mentioned last week, the officers and directors of the publicly traded companies are very much on the sell side. There's a very small percentage of insider buying. Selling has recently been occasionally eight times the amount of buying. Usually, there's three times the amount of selling to buying. In my interpretation, it indicates that the insiders, who have an excellent long-term record for buying when their companies shares are cheap, are finding that few of their own companies are inexpensive. This very high rate of selling to buying augurs poorly for the overall market after we finish this next top. It indicates that the move down will be classified as a bear market for the S&P 500 and the Dow Jones Industrials — we have already had a brutal one in the Nasdaq. But in the meantime, the Federal Reserve Bank's liquefying actions should take the market higher by at least 8% for the Dow Jones, and even more as a percentage for the Nasdaq.

But the question is, can the market go up when it is already selling at such a high valuation level, with earnings that have been/are disappointing and inflation higher than it has been in the last several years? I really don't know, since this is the first time ever that the Fed has acted in this fashion, with the market already so much on the high end of the valuation scale. But the Fed knows all too well that the economy depends on the performance of the stock market.

In the June 11, 2001 issue of Barron's, on page 16, 70 Internet companies are listed that are selling for less than the cash on their balance sheets. I'd suggest that readers take a look.

I want readers to understand that harsh corrections and bear markets give investors the opportunity to invest when stocks are often extraordinarily cheap. It's an opportunity to buy without the constant shilling of overvalued stocks at the high end of their price range by analysts. — *With Robert S. Morrow, Robert S. Morrow Institutional Advisory Services.*