the internet analyst[SM]

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Strong Buys

A Slow Week For Strong Buys

By Paul DeMartino

The Internet Analyst[sm] *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.*

COMCAST (CMCSK): On June 28, Lehman Brothers released a note, explaining its Strong Buy on the shares of Comcast. The note is part of a larger series, titled 10 Uncommon Values in Common Stocks. (That I am featuring a week-old note should give you some idea of the Internet-investing climate this week.) To cut to the chase: "Comcast has outstanding fundamentals — a strong growth outlook, high margins, little competition, resilience to macroeconomic weakness, an iron balance sheet, and an excellent management team." The firm in particular points to "new services growth" and the integration of some acquired cable systems to fuel growth. Lehman values the shares using a discounted cash flow methodology combined with a market value of nonconsolidated assets. This gives a range of $55 to $60, depending on the exact assumptions. Lehman projects share earnings of $0.90 in 2001 and $1.09 in 2002. CMCSK shares closed at $43.04 on July 2.

ECLYPSIS (ECLP): On June 29, Dain Rauscher Wessels reiterated its Strong Buy on medical IT company Eclypsis. The company announced that it would ally with Healthlink, a consulting company. Together, the companies should offer a full solution for hospital IT needs. Dain Rauscher explores it a bit further, noting "on the positive side, Eclypsis gains a broader solution set and the potential for greater software revenue; on the negative side, the alliance may limit upside to the HIPAA-related consulting revenue." (HIPAA refers to compliance with the Health Insurance Portability Act of 1996.) In any case, Dain Rauscher does not believe that this materially impacts its financial projections for Eclypsis. It left its 2001 EPS forecast untouched at $0.46, and its 2002 EPS at $0.72. Its 12-month price target is $29, arrived at by a price-to-earnings ratio. On July 2, ECLP shares closed at $22.27.

Publishing Staff: *Eric Lopkin, Publisher; Paul DeMartino, Managing Editor; Isabelle Sender, Editor, Robin Barrett, Web Designer; Louis Soran, Production Associate, David Allikas, Consulting Editor, Shannon Swingle, Consulting Editor*

Net Effect

Microsoft

So Where Do We Go From Here?

By Eric Lopkin

In 1999, the words Internet and dot-com were magic. Utter the magic words and watch the money appear. The Internet was going to replace television. No one was going to go to a store anymore. Anything you wanted would be accessible from your home computer.

Two years later the magic has given way to reality.

The Internet is not the end-all and be-all that some pundits predicted. It will not replace television and the brick-and-mortar storefront will be with us for a long time. But if the Internet isn't what it was predicted to be, then what is it? Is the Internet really its own sector, or has it grown and evolved to become part of a lot of different sectors? These are the questions we'll be looking at in this column each week. The bubble has burst and now we look at what companies have moved on.

And the first company we look at is the 800-pound gorilla itself: Microsoft (MSFT).

Despite the spin put on the decision by the appeals court by Microsoft, they're not out of the woods by a long shot. In a nutshell, what the appeals court found is that Judge Thomas Penfield Jackson acted improperly, and another judge will have to hear arguments for the remedy. They also found that Microsoft is guilty. Let me repeat that, because it bears repeating: Microsoft was found to be guilty of anti-competitive practices and to be in violation of the Sherman Act.

According to a July 3 report by Salomon Smith Barney, "The most negative aspect of last week's Appeals Court ruling, in our view, was support for the District Court's finding that Microsoft is a monopoly and used illegal tactics to protect its monopoly. This opens the door for competitors, individuals and other regulatory agencies to file suit against Microsoft." The report also pointed out that the decision made an injunction against the release of Windows XP unlikely. The firm reiterated its 1H (Buy, High Risk) rating.

Since the decision, Credit Suisse First Boston reiterated its Buy recommendation and Goldman Sachs has reiterated the stock's placement on its Recommended List. If Microsoft is guilty, why all the glowing recommendations? The answer is relatively simple. From an investment standpoint, Microsoft makes money. Even if the company had been ordered to break up, investors would have gotten stock in both a company that makes the world's best-selling operating system and a company that makes some of the world's best-selling software. (Please note, we're talking about sales and not the relative merits of the software itself.)

However, the fate of Microsoft.NET remains in flux. While Microsoft has put on nothing but the most confident of faces, if they were really that sure of themselves, they wouldn't have required that AOL Time Warner (AOL) not participate in any lawsuits as a condition of bundling AOL software with Windows XP. This was one of many factors that brought those talks to a close. Additionally, Eastman Kodak (EK) has joined the fray against Microsoft, claiming that in Windows XP Microsoft is using its operating system monopoly to force consumers to use their preferred partners for digital film.

While the case is far from over, Microsoft remains a strong company. Will it remain the dominating force it has been? Historically speaking, probably not. No monopoly has been able to continue its dominance forever, regardless of court cases.

Upgrades & Downgrades

Concerns about Check Point Appear Unfounded

By Shannon Swingle

CHECK POINT SOFTWARE TECHNOLOGIES (CHKP): On June 27, CIBC World Markets upgraded its rating on this Internet security solutions provider to Strong Buy from Buy, based on compelling valuation, increased share of the VPN (virtual private network) market, positive channel checks, ability to execute in a tough market, and strong forecast growth going forward. The firm maintained its 12-month price target of $90; the shares closed at $51.37 on June 26.

Because of investor concerns about the company's VPN market share, the stock price has plummeted since the beginning on May, and the stock now trades at a price-to-earnings-to-growth rate ratio of 1.2X, well below market leaders' average of 2.3X. However, market research reports and channel checks belie those concerns. Rather than losing market share, Check Point increased its share to 62% from 52% in 2000, according to Data Monitor, while another market analysis firm, Infonetics, places Check Point's market share of the VPN software segment at 70%, according to CIBC. Channel checks in the United States and Europe have also suggested that Check Point's products are preferred among industry professionals, said the firm. Because of this, the firm strongly believes that the company will meet the Street's second quarter revenue estimates of between $148 million and $150 million and EPS forecast of $0.33. CIBC believes that growth will improve after the second quarter, which is forecast to see sequential growth of 3%. The third and fourth quarters are expected to show 6% and 7% sequential growth, respectively. Year-over-year, growth is anticipated to be 47% to 50%. Research about CHKP was accessed 869 times, and 62 new documents were added to the Multex.com database during the week of June 18 to 24.

J.D. EDWARDS (JDEC): ABN AMRO upgraded the shares of this supply chain software solutions provider to Add from Hold on June 26 and established a price target of $18. The shares closed at $13.39 on June 26. The firm said it changed its rating simply because "there are more positive than negative catalysts for the stock." Those positives include "the acquisition of a customer relationship management (CRM) product, a stabilized services business and a sequentially increasing software license business." ABN AMRO believes that while the company's services business (65% to 70% of revenues) will be flat sequentially—"plus or minus a few million dollars" — revenues should start to increase on a consistent basis in the quarters to come. In addition, the firm believes that software license fees have hit bottom and will rise for the remainder of the fiscal year. J.D. Edwards will acquire new customers thanks to its new OneWorld XE product and will generate more revenue from existing customers thanks to a new CRM product being brought online. ABN AMRO also believes that the company, with new leadership on the right track, will be rolling out new revenue-generating products over the next few quarters. In light of all the potential positive catalysts, ABN AMRO believes the valuation discrepancy between J.D. Edwards and its peers it too large: J.D. Edwards is trading at 1.3X 2002 forecast revenues of $1.13 billion, while the sector is trading at 6X 2002 revenues.

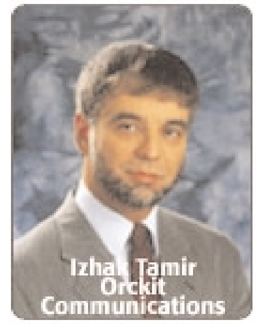
CONVERGYS (CVG): On June 25, Morgan Stanley downgraded its rating on this provider of outsourced, integrated billing and customer care services. The company focuses on clients in industries that include broadband and Internet services. The rating change, to Outperform from Strong Buy, was prompted by a discrepancy in the firm's valuation analyses. The firm's discounted cash flow analysis yields a target price of $38, which is much smaller than its sum-of-the-parts valuation of $57. As a result, Morgan reduced its price target to $38 and lowered its EPS estimates to $1.29 for 2001 from $1.37, and to $1.58 for 2002 from $1.70. Reduced expectations for short term growth at the company's Customer Management Group raised a red flag for analysts, particularly in light of restructuring at AT&T (T), which represents 50% of the division's revenue. However, Morgan likes the look of Convergys' long-term prospects, owing to international expansion and positive growth trends in wireless. The shares closed at $29.15 on June 26, recovering from a low of $27.80 on that day.

Executives Zero In

Orckit Communications

Izhak Tamir, President

Interviewed by George S. Mack



Digital subscriber line (DSL) solutions allow service providers to cram voice, data, video — you name it — onto the same twisted pair copper wire that's been coming into your and your grandparents' homes for more than a century. Turn on your PC, and your DSL is always on. And it's a lot faster than that old 56 Kbps modem that laboriously logs on and ties up your telephone line. Orckit Communications (ORCT) is a major manufacturer and vendor of gear that enables your phone company to give you DSL. Here's a company that has tried to think ahead and anticipate bad news and poor market conditions. But when the economy is bad, it's like a raid on the red light district — the nice little old ladies are swept up and carried away with the riffraff. So, too, has Orckit been affected by the downturn in telecom spending. Moreover, the company is in the midst of a product-line transition that won't be complete until sometime in 2002. I spoke with President Izhak Tamir from his office in Tel Aviv, Israel on May 15, 2001.

[THE INTERNET ANALYST — GEORGE S. MACK] Tell me about Orckit.

[IZHAK TAMIR] We are pioneers in ADSL [asymmetrical digital subscriber line] technology. In the past, we have had the second biggest market share. But starting in the middle of the year 2000, we saw that it would be very difficult to make money in this market, so we gradually moved to an adjacent market using the same technology. One of them is for fiber-optic data communication in metropolitan areas. Another market is the forthcoming IP [Internet protocol] DSLAM [DSL access multiplexor — a central office appliance for ADSL service that combines both voice and DSL traffic on the end user's DSL line. In addition, it splits incoming voice and data and sends them to the proper service provider's network].

[GSM] Which companies are your customers?

[IT] Currently, our customers are the big telephone companies or the ILECs [incumbent local exchange carriers], as they are known in the United States, or the big PTTs [public telephone & telegraphs] in the international markets. Our biggest customer is GTE, which is part of Verizon Communications (VZ). Our second biggest customer is Telia (Stockholm: TLIA) in Sweden. Our new products that we are designing and will be ready in 2002 are targeted to the same market and the same customers. What we are doing now is leveraging the technology we have in house and developing new products for the same customers that we have longstanding relationships with.

[GSM] You have a largely high-level, tier-1 customer base. How did you avoid the CLEC (competitive local exchange carriers) trap?

[IT] Believe me, there was a big debate about that inside the company between 1996 and 1997 and also into 1998, because we knew the prices we could get from the ILECs were much lower than what we could get from the CLECs. The debate was about where to put our priorities. We knew the market was going to be huge, and we decided to concentrate on where we had a competitive edge. The CLEC market seemed very inviting at the time, but it was based on things other than the technology. In Israel, we are very far away from our customers, and we knew that it would be very difficult to compete in a market where technology was not the key differentiator. Our main strength has been and is technology. This is where we come from. When we looked to see where our advantage was, we saw it certainly was the ILEC customers that appreciated our technology, and that's where we had a competitive edge.

[GSM] So you exercised what turned out to be good judgment. The driving factor was one of geography, because you were far from your customers.

[IT] You can look at it as geography or luck. But when you make the right decisions, it's always an issue of judgment as well as timing.

[GSM] I'm interested in exploring this further; because even though we're talking about the past, investors are interested in management's thought process. So let me ask you this: Did the CLECs ask you for financing, and is that one thing that scared you off?

[IT] Yes. Actually, without mentioning names, one of the first and one of the most successful CLECs came to us. We had very good personal connections with the management and the founder. We knew them from their previous company. They visited us in Tel Aviv even before they got their initial financing. And when we looked at their business model, we said it was impossible for us to compete, because Lucent Technologies (LU) or Alcatel (ALA) could give them financing and much better terms than we could give them.

[GSM] Is there another example of judgment you want to share?

[IT] If you want another instance of judgment and timing, it was our decision in May 2000 to get out of the ATM [asynchronous transfer mode] DSL market, which is the majority of the market today. At the time, we had the second biggest market share. We were the biggest supplier to Deutsche Telekom (DT), but we got out of this market because we saw that without raising $200 million to $300 million, we couldn't continue to deliver to the customers and survive in that market. We did raise more than $120 million in March 2000, and we realized that would be the last [capital] we would be able to raise. We then made a simple judgment that we would not be able to continue with ATM. That's what caused our stock to fall from $90 to below $10 per share. That was before the collapse of the market, and we got a lot of criticism. People wanted to know what we were doing — leaving customers like Deutsche Telekom, where we had the second biggest market share, as well as the Israeli PTT and many others. Today, people can understand, and we get a lot of telephone calls. They realize how smart we were in leaving those customers. Now we are concentrating only on the IP portion of the market — not ATM, even though it's still the biggest part of the market today.

[GSM] Certainly you would never trade places today with those companies that chose the CLECs as their market. But it's a two-edged sword, because you're operating with a very narrow customer base today. How much of your first quarter revenue came from Verizon (GTE)?

[IT] We don't publish this information per quarter, but in the year 2000, 60% or 62% of our revenues came from GTE.

[GSM] What about Telia? How much came from it?

[IT] I don't remember exactly, but in our first quarter conference call, we did say that we had two customers that were above 10% of our revenue. In other words, two customers — one being Verizon and the other Telia — represent more than 10% of our revenue.

[GSM] Can we look for an announcement this quarter about a major new customer?

[IT] No. You'll not see an announcement this quarter. Since we left the ATM DSL market a year ago, we cut the R&D activity in that area and started to develop two product lines. One is the Corrigent and the other is the IP DSLAM. These products will be available next year. This year, in 2001, we are depending on revenue from existing customers, and we are quite optimistic about these revenues. I believe we are going to see growth of about 15% in 2001, relative to the year 2000. We still have the same forecast we published in June 2000, which is very rare. Most companies have changed their forecasts a lot since then.

[GSM] What about the future?

[IT] Our future is heavily dependent on the $30 million that we are putting in our two new products that will be ready in 2002.

[GSM] I understand you're moving to outsource some manufacturing to SCI Systems (SCI). Is this for your new Corrigent product line as well as your IP DSLAM?

[IT] It's for the overall manufacturing of the company — for the old products and the new products. Instead of being a company with 300 people for manufacturing, we are now about 50 people who are dealing with outsourcing, including prototyping. In the first quarter, we completed the transition to outsourcing. Everything is now being done by SCI.

[GSM] Briefly explain your Corrigent product line. What is it?

[IT] In the metro areas, there is a problem of bandwidth, for which there are many solutions. Many companies are pushing the Ethernet solution, but the problem with that is twofold: First, Ethernet doesn't support voice. Second, recovery time is not quick if you're having a problem. With our Corrigent solution, we address these two problems. First, we integrate voice and Internet together, and second, we support a recovery time of 15 milliseconds. This is based on an evolving RPR [resilient packet recovery] standard, which I believe many companies in the industry are starting to support. This solution gives the customer the good things from the Internet, as well as the recovery time of SONET [synchronous optical network].

[GSM] How long is it going to take for your Corrigent and IP DSLAM products to start generating revenue?

[IT] It will be in the year 2002. We will not see any revenue from them in 2001.

[GSM] So we should certainly see the result of these two initiatives on your first quarter 2003 income statement, is that right?

[IT] Certainly, we will see a lot of it then.

[GSM] Between the fourth quarter of last year and the first quarter of this year, you allowed your inventory to run down, and your cash position ran up from $10 million to $112 million. Will that cash see you through until we begin to see positive cash flow from your new initiatives?

[IT] Yes. In the next quarter, we're going to see a significant reduction in inventory, because SCI is going to buy our inventory. This will release a lot of cash. On the other hand, receivables are going to grow because the second quarter is not going to be as front-loaded as the first quarter. I believe that we will end this year with about $90 million to $95 million in cash. So I would say that cash is not an issue for the next two years.

[GSM] Is DSL still a growth industry?

[IT] I believe the DSL market is going to grow significantly, both in the near and long terms. The question is how will the market be divided between the different flavors of DSL. Margins are shrinking with ATM — and by the way, Nortel Networks (NT) announced that it was getting out of that market last week. We support the other flavors of DSL, which are IP and DSLAM. But it's going to take them a longer time to grow. We think our timing is perfect with the IP DSLAM. It will have much better gross margins.

[GSM] Now what about your Corrigent metro market?

[IT] There is no doubt about it that metro is a booming market. The question or the risk is which one of the product solutions will prevail. I believe they will live in the marketplace together. It's just like what people were asking me three years ago: Which is going to win — cable or DSL? Everybody will have enough bread to eat.

[GSM] How big are your addressable markets?

[IT] Both of them are in the billions of dollars. Last year, the total DSL market was close to $2 billion, and now the metro market is just taking off. But in the years 2003 and 2004, we will see billions of dollars of addressable market.

Vital Statistics
Orckit Communications (ORCT)

Market Cap:	$42.9 million
Shares Outstanding:	21.16 million
Recent Stock Price:	$1.91 (06/29/01)
52-Week Range:	$30.12 – $1.08
Price to Estimated (2001) Revenue:	0.25-times

Years End In December	EPS	Revenue in millions
1999A:	($1.39)	$88.9
2000A:	($1.66)	$130.3
2001E:	($1.12)	$151.4

Source: U.S. Bancorp

The Real Deal

Nasdaq's Glitch A Short-Term Hiccup

By Charles Payne, Wall Street Strategies

A lot has changed in the stock market over the last year and a half, but perhaps the most profound change is the over-thinking and over-analysis of news and events. The new Millennium has ushered in a new type of investor, sort of like the homo erectus yielding to the Homo sapiens. Like our ancestors who became better hunters and gatherers via improved and sophisticated tools, investors roamed the investment world spearing any stock in sight armed with the Internet, charts and CNBC. Then came the

Ice Age, the period we are currently hoping will pass, or has passed. Even if we are in the midst of a thaw it looks like the psychological makeup of the investor has changed. Most investors are now approaching the stock market as if it is an agricultural endeavor. They seem content to let nature take its course and watch and wait for the bloom. They've lost all nerve needed to enter into would-be hostile territory. Instead of engaging in conquest they'd rather sit in their caves and occasionally pick berries.

You don't have to be an anthropologist to know that band societies continuously evolve, and the stock market is no different. In fact, it will be hard to keep investors down on the farm once the market heats up. At times last week it looked like the market was trying to do just that. Unfortunately, a series of events, including homo-sapiens mishaps to general investor reluctance, kept the budding rally in check. However few would disagree that last week's actions were a win for stocks and a boon for investor confidence. Just about every major index that covers equities closed higher this week. (The Dow and S&P were off slightly 0.96% and 0.08% respectively.) By the end of the week, the buzz was over the action of the markets — the resiliency not the rottenness. Yet, as Murphy's Law would have it, every time the market wanted to take-off, some type of glitch would stall the move.

On Friday, Nasdaq ran into technical difficulties that interrupted trading for the last hour and a half. The officials at Nasdaq had the bright idea of extending trading hours to 5 o'clock EST to make up for the inconvenience. Not only was it a ridiculous gesture (people stop trading early on Fridays, especially in the summer) it actually made things worse. Some may call it poetic justice (especially those that lost it all in tech stocks) that the index that is essentially the proxy for tech issues shut down because of technical problems. Beyond fodder for comedians, the breakdown of the system is alarming, particularly coming on the heels of a 20-minute glitch on Thursday. Unlike the leaders of the NYSE who remained mum on the source of their recent technical problems, the folks at Nasdaq threw out Worldcom (WCOM) as the culprit (again poetic justice at work). Bernie Ebbers has become the fall guy for so many things that Friday's embarrassment will not mean much until the SEC decides investors have to be repaid for faulty trades. Anyway, I still believe that Nasdaq is the stock market for the next 100 years, give or take a blackout or two.

I think the lesson learned is not only from the Nasdaq "glitch" on Friday, but also from other efforts to control the movement of stocks and the market at large. The latest example came from the halting of Microsoft (MSFT) trading on Thursday. When the stock was "halted" for the dissemination of news, the rumors ran wild that the shares would reopen ten points higher. Of course, that proved not to be the case, and I think there was a psychological letdown that triggered selling across the board. That isn't uncommon; in fact it is only logical that one's mind will come up with its own assumptions when a stock stops trading. I really can't remember a time when a stock was halted and didn't trade with a stigma upon opening. It's a bad idea to stop stocks from trading and it's even worse when entire exchanges are halted.

The Ice Man Cometh

If, indeed, the last year and a half becomes known as the Ice Age (I better get some royalties) then it will be exemplified by the actions, mannerism and nerve of the Federal Reserve chairman. Once again, Mr. Greenspan had the world riveted with suspense going into last week's FOMC gathering. The Street seemed to be split down the middle with 48%, including yours truly, believing the Fed would cut the Fed funds rate by 50bps and 48% believing the fed would only slice 25bps of those rates. (The other 4% thought the Fed would either stand pat or raise rates, but that group also believes Elvis lives and the check is in the mail.) Earlier in the year when the Street became excited about the prospect of dramatic rate cuts, it only led to disappointing selloffs once the actual decision was released. That wasn't the case last week and that may have been the number-one "buy signal" we've seen all year.

There are several ways to look at the situation, but the Street decided to see the positives. Maybe the folks at the Fed see the economy turning and want to stand back and watch their previous handiwork make an impact. Of course, they also have the luxury of knowing that the rebate checks destined to hit mailboxes any day now (or at least that's what 4% of the population believes) will probably serve as the equivalent of a 50bps rate cut. Furthermore, though the Fed didn't comment on the state of the economy, most think they've left the door open for additional rate cuts. If the rose-colored glasses' response to the Fed's action proves to be 20/20 and the economy is turning, then it should trigger a chain of events that will lead to a much higher stock market. First the economy heals, then corporate profits improve, and finally stock prices improve. Once again, people believe that such a string of events is possible and look for stock prices to improve at a faster rate than the other dominoes to recovery. The Fed doesn't meet again until August, so the month of July is going to require a lot of blind faith and a couple of positive news items if there is to be a summer rally.

Breaking Up Is Hard To Do

Everyone called it a victory, including the state attorneys that forced the case to begin with and the new US attorney general John Ashcroft. However, with a unanimous 7 to 0 vote, the U.S. Court of Appeals reversed the breakup of Microsoft. The judges did agree that the company acted like a caveman and dominated its competitors in a monopolistic fashion. Still, the news sends everyone back to the drawing boards and at the very least gives Microsoft another three years to rock and roll. The reality is that the company will come to some type of settlement with the Bush administration, but it is highly unlikely that the company will be split in half. On the conference call, Bill Gates made a point of saying the company stayed "focused" on product work. Singling out the old and new developments like "office XP", .NET, Windows XP and the X-BOX, among others. I'm sure this was to assure shareholders that, unlike IBM (IBM) — that company waged a war against the Justice Department for the entire decade of the 70s and lost its "focus" — Microsoft will keep its eye on the prize(s). Speaking of prizes, the company also made it known that they are trying to work with competitors, specifically AOL Time Warner (AOL), when it comes to the Internet. The stock was a bit higher but it was no secret that the Street has always expected a friendly deal with the new administration, so the news was already built into the share price.

While Microsoft gets to remain the same, other companies are working diligently to change their focus (that word again). The one to watch is Compaq (CPQ); the company appears to be adopting the IBM model and is ditching chips for service. I think the plan to go with Intel's (INTC) Itanium chips is a move in the right direction. The decision was highlighted by the bold move made by the company to transfer employees and technology to Intel. This, coupled with the recent news concerning the rapid growth of IPAQ, beleaguered investors should feel that Compaq is on a roll. I haven't been a fan since the Digital takeover, but I'm beginning to warm up to the company. At this level the stock has a great risk/reward ratio.

The Week Ahead

Though the week of July 2 to 6 will be interrupted by Independence Day smack dab in the middle, there are still plenty of scheduled news events that could create fireworks in the market. The economic calendar is chalked with market altering news like the NAPM report and the jobs data on Friday. There were interesting trends developing last week that should carry over into this week. There is a transition from safe stocks and Blue Chips back into big Nasdaq names and small caps. Next week should also see the last of earnings warnings and that puts a level of confidence for shareholders of companies that haven't warned.

Several stocks are on fire and look like momentum stocks of old. The list includes Serena Software (SRNA), just about every storage network issue/fiber channel stock lead by QLogic (QLGC), and Barnes and Noble (BNBN) hit a new 52-week high in part to excitement of the sale of video games. (I always liked the management but lost track of this stock a long time ago.) Video games continue to propel the individual stocks to new heights and the key beneficiaries are NVIDIA (NVDA), THQ (THQI) and Electronic Arts (ERTS). There is a lot of hype around the space, tread with caution. By the way, gaming/gambling is also a great trading space.

Buying the dips has been evident for some time, but it has occurred with the larger names. Now we see it with the smaller names. On Friday, Liberate Technologies (LBRT) was hit after an earnings miss and warning, but the shares made a U-turn and came from a low of $8.40 to close at $10.95. I see more and more of that happening going forward.

I think money will continue to come out of the Blue Chips and find a home in the oversold tech issues. I think we are on the cusp of true wealth creation opportunities that will be more than a flash in the pan. For the immediate near-term, it will still be about trading, though instead of looking for a couple of points we can start looking for, and getting, 5 to 6 points or more. If you watch the market, even on a passive basis, you'll find yourself grunting, sprouting additional body hair and possibly growing a tail. Don't go to the doctor, it's just your inner caveman emerging. Go sharpen a stick and get ready to go wealth hunting. Though we are still a few weeks, perhaps a few months, away from going ape over the market, investors seem ready to kiss and make up and take the plunge again.

Venture Capital

The Five-Tool Diary: Finding Your Way Home Again… Part II

By Stephen DeNichilo

Last week, we tested the first two criteria in our quest to evaluate Return Path and find a profitable private investment. Let's review:

1. Smart dynamic management with an ability to think outside of the box. Total points: 3 out of 5 — Strong management with relevant experience.

2. A feasible, scalable business plan in an emerging industry. Total points: 4 out of 5 — Sounds good. The company is solving a problem, and the questions about consumers' willingness to forego e-mail addresses will disappear as it adds more companies to the network. Revenue potential might be a question, though.

Boy, Return Path is off to a solid start, but it will take a little more convincing before I bestow the Five-Tool designation on this young, unproven company. Let's see if it can keep it up.

3. Sustainable barriers to entry.

There are some competitors out there. A private venture-backed company called ActiveNames has received decent press for its product, but it differs slightly from our friends at Return Path. ActiveNames is more focused on the individual and offers a free download of its software on its site to become a personal secretary and update everyone when an address is changed. When the address changes, companies are notified and can request the e-mail address from the individual. This sure seems like an arduous process. Can you imagine Amazon.com (AMZN) responding every time one of its customers changes an e-mail address? Another competitor, Changed E-mail, based in Atlanta, seems to be a small second-tier player.

At first glance, Return Path is the clear leader in solving this growing problem. While it holds no superior technological advantage over a possible future contender, the power it wields comes from its relationships, contracts and backers (which we will look at in the next section). Outside of Return Path's relationships, anybody can set up a network geared toward keeping fresh e-mails.

The relationships Return Path forges create the barriers to entry, but when a company is not based on a core technology, there is always room for someone to sneak in.

Total points 3 out of 5 — Clear leader, but you never know if a larger company will enter the space.

Strong board of directors, advisory boards and past investors.

These guys do well in this category, based on who has written the checks. In mid-October 2000, Return Path closed its second round of funding as DoubleClick (DCLK), Flatiron Partners and Chase Capital Partners infused $7.7 million to further the company's efforts. In addition, DoubleClick, the Internet advertising giant, has the option to invest another $10 million during the next year. As part of the financing, Jonathan Shapiro, senior vice president at DoubleClick, and Philip Summe of Flatiron will join the board of directors.

These are solid investors. Chase Capital Partners is a titan in the venture capital world and, according to Venture Economics, is one of the industry leaders in dollars invested. Flatiron, a subsidiary of Chase Capital Partners, has risen to prominence as New York's premier Internet VC, with notable investments such as our own Multex.com (MLTX).

The two VCs give the startup solid "smart money" backing, but the brass ring is the DoubleClick investment. If there were any relationship that I would say Return Path needed to establish, it would be with DoubleClick. DoubleClick is the leading global Internet advertising solutions company. Combining state-of-the-art technology and media expertise, DoubleClick helps advertisers and publishers make Web advertising work by successfully centralizing the planning, execution, control, tracking and reporting for high-impact, online media campaigns. Customers go to this company for focused ad campaigns, which will always involve e-mail blasts. This will likely prove to be a big door opener for our young upstart friends.

"We look forward to working with Return Path to help them build the standard e-mail change-of-address service," said Kevin Ryan, CEO of DoubleClick, in a press release. "In addition, this investment will enable DoubleClick to help its numerous e-mail clients reduce wasted marketing dollars by putting an end to e-mail churn by offering them a proven and robust solution to easily manage their e-mail databases."

I believe DoubleClick's involvement will allow Return Path to hobnob with exactly the type of businesses it needs to be around. The company has three solid investors, and in a shaky market environment, that says something.

Two points for the two VC firms, two for the DoubleClick relationship, and one point for raising money in a dismal climate. I like what I see.

Total points: 5 out of 5 — Strong investors.

5. A realistic exit strategy.

In order to attain an exit strategy (IPO or M&A), you must create value. Return Path certainly seems, dare I say, on the right path. I don't doubt the need for Return Path, but I do question the company's revenue model. Unless I am mistaken, it will receive revenue whenever an individual successfully updates his e-mail address with fellow network partners, and a partner will pay a small fee for this information. Only time will tell how people will react to the product. Return Path Chairman and CEO Matt Blumberg believes that while the company is still too young to contemplate an exit strategy, the business plan can stand alone. Return Path faces typical questions that any young company grapples with, and in this atmosphere, an IPO doesn't seem to be in the cards.

With DoubleClick's obvious vested interest in the company, a network flush with partners with large client bases will be a priceless advertising tool for any marketing company. DoubleClick's option to invest another $10 million shows that if Return Path produces, DoubleClick will take a larger position in the company. In fact, it would make total sense for the company to buy Return Path outright. There seems to be a clear exit here.

Total points: 4 out of 5 — DoubleClick's option to invest down the road makes Return Path a likely acquisition target.

Total Return Path Five-Tool points: 19 out of 25 = 76%

Ding, ding, ding…folks, we have a winner. This company gets a gold star. Return Path is the first company to survive the rigors of the Five Tools, and it should collectively take a bow. For a young company, Return Path has developed a logical business plan and positioned itself with the right management and backers. With a little luck, e-mail churn will be as obsolete as a Red Sox World Series championship hat. Sorry Beantown, I had to take a jab.

The Five-Tool Diary is a simple, objective look at private companies, using a predetermined screening process. The Diary is not a science nor is meant to have the final conclusion on a company. The series merely attempts to prove that individuals can successfully evaluate private companies using common sense, public resources, and five simple steps.

Analyst's Spotlight

Yahoo!

Rob Martin,

Analyst, Friedman, Billings, Ramsey & Co.

Interviewed by Taylor Smith

The Internet Analyst℠ *recently spoke with Rob Martin, who covers the digital media industry for Friedman, Billings, Ramsey & Co., about Yahoo! (YHOO). The stock recently closed at $19.04, which was 86% off its 52-week high. (The shares closed at $19.38 on June 28.) The analyst holds no shares of Yahoo!, and Friedman, Billings, Ramsey has done no investment banking work for the company.*

[THE INTERNET ANALYST — TAYLOR SMITH] What has been happening with the company recently?

[ROB MARTIN] Yahoo! is still weathering the overall slowdown in the online advertising space and is still going through a transition period. CEO Terry Semel, who replaced Tim Koogle this spring, is currently taking time to determine what key assets and attributes of Yahoo! need to be emphasized and what changes need to be made within the company.

[TS] Can you speculate on what some of these changes may be?

[RM] One possibility is that Yahoo! will potentially flip the switch on some of its free services and start charging customers for such services as the company's calendar, e-mail and instant messaging. The downside risk is that Yahoo! may lose a big chunk of its registered users, but charging for these services could significantly boost incremental revenue.

[TS] Would charging for these services be a good move strategically?

[RM] We've looked at the upside and downside of the equation, and now we think that the revenues gained from charging subscribers for some Yahoo! services would outweigh the risk of losing some subscribers. Yahoo! has 60 million registered users who are signed up for two or more services, and if 6 million — which is just 10% — of those users each paid between $5 and $10 per month, the financial benefits would be huge.

[TS] What is your rating on the stock?

[RM] I currently have a Market Outperform rating on the stock. I'm looking for revenues in 2001 to reach $719 million, with earnings per share of $0.04. Next year, I expect Yahoo! to generate revenues of $872 million, with earnings of $0.11 per share.

Vital Statistics
Rob Martin, Friedman, Billings, Ramsey & Co.

Education: MBA, George Washington University
Industry covered: Digital media
Companies covered: AOL Time Warner (AOL), CNET (CNET), Ticketmaster (TMCS), RealNetworks (RNWK), SportsLine.com (SPLN), Virage (VRGE), Yahoo! (YHOO).

IPO Update

IPO Market Witnesses Massive Decline in Q2 Issuance

By Jeffrey R. Hirschkorn

The second quarter IPO market was definitely a major improvement over what transpired in the year's first three months. Still, the quarter was held back over economic concerns and profit warnings. Those problems led the Federal Reserve to ease rates at each meeting of the Federal Open Market Committee, thus creating a more investor-friendly environment. By lowering rates in a highly questionable market, it allowed underwriters to carefully admit new entrants to the corners of Broad and Wall Streets.

At the beginning of the second quarter, investors were clearly fascinated with energy issues. After that fad began to fall out of favor, medical diagnostic and healthcare firms took center stage. Moving along, insurance IPOs gained momentum towards the end of the second quarter. However, none of those sectors could overcome the dominance and potentially market-setting IPO from Kraft Foods (KFT).

"The second quarter of 2001 for IPO investors was like one long flight delay at LaGuardia Airport," said Renaissance Capital Management, in its recount of the IPO market. "As the quarter progressed it became evident that a rally in the IPO market might be late, and underwhelming in its initial scope, but it would get there."

Added Joe Hammer, director of equity capital markets at Adams, Harkness & Hill in a recent interview: "The slower IPO market produced stronger IPOs this quarter. We've got a decent tone to the market and a select number of quality deals are getting out. Everyone is being careful about the quality of offerings being scheduled."

Improved Deal Flow for Q2

For the quarter, 28 IPOs priced for trading, totaling $18.6 billion in global dollar volume. Of that group, Taser International (TASR) is excluded from calculation because we don't include unit sales in our aftermarket statistics. That easily bests what investment bankers were able to accomplish during the first quarter. During that period, 20 companies debuted, totaling $8.3 billion in worldwide proceeds.

According to confidential sources, the Kraft IPO was a major spark plug in the second quarter. While it ended the quarter unchanged, the market was able to support the second largest domestic IPO in history. The biggest: $10.6 billion IPO from AT&T Wireless Group (AWE).

While we witnessed a strong increase in deal flow during the second quarter of 2001, it falls way short of what the world of equity syndication accomplished last year. In the same period, underwriters launched 99 IPOs, totaling $33.6 billion, reports The IPO Hardball. Let's not forget that during last year's second quarter, the dot-com shakeout was in full swing. Therefore, many of those deals are probably trading at bankruptcy clearing prices, if not closed already.

Clearly, the most IPOs occurred during 1996 when 257 transactions took place, raising $18.9 billion. Still, 2001's issuance pattern wasn't the slowest since 1980. According to IPO Hardball, our worst period for deals came in 1980 when only 24 firms debuted. However, the worst year since 1980, in terms of dollar volume, happens to be 1982 when investment bankers raised a paltry $173 million.

Second Half Preceded by Solid Q2 on the Composite

To put things in perspective, market analysts agree that the first quarter was nothing to write home about. Let's refresh everyone's memory. The core measurement of the IPO market's success happens to be the Nasdaq Composite. Indeed, 75% of IPOs are launched on the tech-laden index. It should be noted, however, that during the second quarter, 14 new issues actually listed shares on the Big Board. With fewer companies on the launching pad, stronger stocks (with profits and a successful business plan) can debut on the New York Stock Exchange. Remember that the NYSE has extremely tough listing requirements.

Overall, issuers and investment bankers were scared from the table in the first quarter and it was clearly felt in the Composite's return. For the first quarter, the Composite tumbled 26% to 1,840.26. At the time I penned the First Quarter Review, analysts I spoke with were highly concerned that even if the markets find a bottom, it will take a long while before a solid flow of action returns. They were right. The shakeout of weaker companies continued in the second quarter. It cleared the runway for firm's that brought special characteristics to the table.

Fast forward to June 29! A strong quarter was just entered into the books for the Nasdaq Composite. For the three months ended June 29, the Composite gained 17.5%, clearly outpacing the returns of both the Dow Jones Industrial Average and the S&P 500.

"With the exception of the Nasdaq, the indexes ended nearly flat for the week as market participants positioned themselves for better times in the second half of 2001," wrote CNNfn in a recent market article. "Market participants were more than happy to bid farewell to a six-month period full of dismal news. From the start of the year, the Nasdaq is down 12.5%."

Added Edmund Cashman, executive vice president of Legg Mason Wood Walker: "It's back to fundamentals: companies with earnings." While Legg Mason isn't a major player in the lead managing of IPOs, it did participate in a number of offerings during the second quarter as co-manager or deal participant. Like most of the Street, Legg Mason was a deal participant in Kraft's mammoth IPO.

Momentum is Building for Strong Second Half

On the other hand, equity heads feel that momentum is building for a better second half. The late quarter surge in tech stocks came from the U.S. Appeals Court. The court overturned the initial ruling that called for a breakup at Microsoft for violating anti-trust laws. While the decision calls for a new judge to review the case and determine the penalties Bill Gates should accept for violating those laws, the decision was clearly pro-business, thus causing a run-up in technology issues.

Analysts we chatted with shortly after the markets closed indicated that while the second quarter reflects a modest rise in the number of IPOs, we still have a long way to go. Some expect the third quarter to bring more strong candidates to the table –but with total issuance more in line with what transpired in the second quarter. At this point, July's IPO calendar only reflects a few candidates, of which Accenture (ticker: ACN), is expected to be the headlining deal. Goldman Sachs and Morgan Stanley are joint book runners on the $1.6 billion offering.

"There seems to be more confidence out there," said Mike Murphy, head of equity trading at First Union Securities in a recent market interview.

Added Bill Cheney, chief economist at John Hancock Financial Services (ticker: JHF) in an interview with CNNfn's Before Hours: "I think we're toward the end of a period of real weakness and, by the third quarter, all the money Alan Greenspan and the Fed have been pumping out will start to be spent."

Of course, six interest rate cuts by the FOMC and the landmark reversal of the Microsoft decision was enough cause to lift market sentiment heading out of the second quarter. Traders tell me that they feel positive momentum is building on the Street and it should lead to a stronger second half.

Jeffrey R. Hirschkorn is Managing Editor for the Wall Street Reporter Magazine. Send comments to jeffh@wallstreetreporter.com

Rants and Raves

Take advantage, don't be taken advantage of

By K.C. Grainger, Granger Beaulac

It seems like years ago in the stock market, but it was only a year and a half ago. I was doing my charting in an office where day traders were lined up, sometimes fourteen deep in front of the various quote and charting screens in Montreal. One extremely ecstatic trader slapped me on the back and bragged, "my account is up over 60% in the last four weeks, K.C." That was a key sign that it was almost the end for the ludicrous nonsense of incredibly overvalued stocks in North America and yes, the rest of the world. Within three months that room was virtually empty of day traders. The market, as it always does, began the process of correcting the excesses.

When I warned of the overvaluation here on *"The Internet Analyst"* while Internet stocks were making price highs, I used a technical analysis standby, the "angle of ascent" to determine that the move for the Internet and high tech stocks was not sustainable and would come down–with a vengeance. And did they. Recently, I have noticed that there is almost the same degree of utter despair for those stocks that there was excessive craving for over a year ago. There are many that can be bought for excellent capital gains that should occur within the next several months. Who is going to lead the world in technology? Ford (F), Exxon (XOM) or General Motors (GM). I doubt it.

The point is that one can always find numerous stocks that are true bargains and exceptionally undervalued. You just have to wait patiently until they come into a "buying zone": a price that is technically near a bottom and fundamentally undervalued. And you must sell at least part of your position if there is a rally of substance. A certain percentage of stocks are sold as a market makes a top; those sellers are the "profit takers" who take advantage of the moves up. They are usually professional traders and hedge funds, rarely the small investor. The market no longer offers exceptional potential for the investor who invests for the long term. Some profits must be taken if one wants to outperform the market. The old "buy and hold" philosophy is fine if one is buying at a multi year low in price and the stock is exceptionally undervalued (perhaps accompanied by heavy buying by the company's insiders) Yet for safety and a better performance, at the very least some profits must be taken. Why let the lion's share of profits be taken by professionals and not the small investor?

Look at the recommendations that we suggested in the April 19 Rants and Raves. Some have already come very close to our upside targets and will go further up. We still stand by them. But as we said many times, we believe that the next top, which we expect to warn you of when it occurs, will lead into a very painful bear market. *— With Robert S. Morrow, Robert S. Morrow Institutional Advisory Services*