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NEWS ANALYSIS TECH

By Jim Kerstetter

## Why the Tech Bulls Aren't So Brave

**Their optimism wasn't zapped by one event so much as a combination of mixed earnings news, rising inventories, and spooked buyers**

In May, the tech analysts at AMR Research surveyed about 200 corporate-tech buyers and asked them about their spending plans for the rest of 2004. The latest results of the quarterly survey revealed the greatest optimism in more than three years. Tech, it seemed, was back. Then, shocking nearly everyone, the optimism went out the window a month later with a spate of bad earnings news. "We felt like fools," says Jim Shepherd, senior vice-president of Boston-based AMR Research.

So what happened? Shepherd figures a combination of a lot of little things in the economy may have made already cautious buyers put off making any major decisions as the June quarter ended. "I think it was a tipping-point situation," he says. "There was no single event that caused it." Be it rising fuel prices, a disappointing increase in the number of new jobs, or a lingering fear of terrorism, buyers balked at the last minute.

**SINGLE-DIGIT GROWTH.** And they're still balking. Mixed earnings news on Aug. 10 from networking bellwether Cisco Systems (CSCO), on top of inventory buildups at other trend leaders such as Intel (INTC), fueled concerns that tech's comeback isn't what many thought it would be. National Semiconductor (NSM) and chip-equipment maker Kulicke & Soffa (KLIC) offered similarly cautious outlooks.

"It's too early to push any panic buttons, but certainly you have to be somewhat concerned by the fact that this doesn't feel like your average, regular, historic recovery," says Laura Conigliaro, a managing director at Goldman Sachs (GS).

It appears that the robust tech recovery the bulls envisioned simply won't materialize. The latest estimates suggest it'll be half of what they expected, at best. Conigliaro says barring the sudden arrival of a significant new technology trend, tech may be stuck at 3% to 5% annual sales growth for the foreseeable future -- about half the industry's historic levels and plenty less than the double-digit growth some optimists expected for this year.

**STARTUPS HURT, TOO.** "You've got a...sustainable capital-spending environment," says Tobias Levkovich, chief U.S. equities strategist at Citigroup SmithBarney (C), "but not at a level that some people may have been expecting." With little new technology on the market, it's easy for buyers to put off purchases when they're still worried about the economy, Levkovich says. Buyers simply aren't approaching the market with any sense of urgency.

It doesn't appear that 2005 will be much better, either. Estimates of semiconductor sales, a leading indicator for the rest of the tech sector, are coming down. RBC Capital Markets semiconductor analyst Apjit Walia says earlier predictions of 15% to 18% chip-sales growth in 2005 are too high. They'll more likely be in the high single digits.

The slowdown isn't limited to public companies. Private venture-capital-backed startups are feeling the pinch,

too. "We had a very good first and second quarter this year, and everyone assumed we were back in full gear and headed toward recovery," says Gary Morgenthaler, general partner at venture-capital firm Morgenthaler Ventures. "Now we're seeing a flattening of growth in our portfolio companies. I think everyone is trying to assess whether the recovery got ahead of itself."

**"SPOTTY RECOVERY"** For investors, that means tech is a crap shoot. Sales at Cisco were up 26%, to \$5.9 billion, and net income was up 42%, to a record \$1.4 billion in the fiscal quarter that ended July 30. But in a somewhat troubling sign, Cisco's inventory rose 8%, to \$1.21 billion. Chief Executive Officer John Chambers was characteristically understated in a call with Wall Street analysts on Aug. 10. "Given recent economic data points, most of the CEOs I talk with...are a little more cautious in their optimism than they were a quarter ago."

Chambers says projected sales growth of zero to 2% in the current fiscal quarter is a result mostly of seasonality, not of any overall drop in business activity. "This is pretty close to what we have projected over the past few quarters," he says. That hardly soothed nerves on Wall Street. Cisco shares dipped 10.1% to \$18.39 on the day after its earnings news, leading a broad decline among tech outfits. The sector's weakness helped push the Nasdaq Composite Index down 1.5%, or 26.28, to 1,782 on Aug. 11. At one point during the day, the tech-heavy index dropped to 1,760, its lowest point since August of last year.

Juniper Networks (JNPR ) CEO Scott Kriens argues the technology recovery isn't stalling. Instead, he says, there's a new reality. "The tech recovery will be checkerboard," Kriens says. "It won't be marked by 'a rising tide lifts all boats.'" Discriminating tech buyers are most likely to consolidate their purchases around a handful of suppliers, leaving tech's also-rans in an increasingly precarious position. Adds PalmSource (PSRC ) CEO David Nagel: "It's been a very odd, spotty recovery."

**AWAITING DELL.** While consumer-technology sales are still strong, some fear that demand for devices such as PCs, liquid crystal displays, and cell phones will wane during the second half of the year. On Aug. 10, Lehman Brothers (LEH ) analyst Tim Luke downgraded the entire chip sector. RBC's Walia predicts rising inventories, higher oil prices, and rising interest rates will all add up to slower growth.

All eyes will be on Dell (DELL ) when it reports earnings after the market closes on Aug. 12. The PC maker is expected to report yet another strong quarter, with sales up 19.7% from last year. But investors will be most interested in Dell's forecast. What Dell execs have to say about back-to-school spending and a potential fourth-quarter spending flush among corporate buyers will either add to or dispel the growing tech gloom.

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