

Our Outlook for Technology Stocks

A closer look at winners and losers in mobile devices, the hot storage hardware industry, and tailwinds in semiconductor equipment.

By Toan Tran, Associate Director of Stock Analysis

- ▶ The separation between the winners and losers in the mobile device race continues to widen.
- ▶ Storage hardware continues to be a hot area in technology.
- ▶ Increased capital spending by chipmakers will benefit the semiconductor equipment industry.

Industry-Level Insights

Our long-held thesis that the mobile device market would come to be dominated by a limited number of software platforms continued to play out in the second quarter. The two leading platforms, Apple's AAPL iOS and Google's GOOG Android, further extended their dominance by shipping millions of devices to users and recruiting more developers to build apps for those users. Apple received 600,000 preorders for the iPhone 4 on the first day of availability, despite problems on AT&T's T end that dropped many customer orders. The iPad, another denizen of the iOS ecosystem, has racked up sales of 3 million units in the first 80 days. On the Android side, Google CEO Eric Schmidt has stated that over 60,000 Android devices ship each day.

The momentum behind the iOS and Android ecosystems is likely unstoppable at this point, which was the catalyst behind our decision to move the formerly narrow-moat rated Nokia NOK to a no-moat rating. We had given Nokia the benefit of the doubt given its distribution advantage and ownership of strategic assets such as Navteq, but at this point, a full three years after the original iPhone, the firm's smartphone strategy remains in complete disarray. Nokia will clearly not be a player in the smartphone market and is likely beginning a long secular decline.

We have highlighted storage hardware as a growth area over the past 18 months, and the sector continues to perform well. As just one example, NetApp NTAP reported 33% year-over-year revenue growth in its recent quarterly report. NetApp's quarterly revenue of \$1.2 billion is now far above its predownturn peak of \$940 million. The market has priced in much of the good news in storage, but one name to keep an eye on is Compellent Technologies CML. The shares trade at a roughly 20% discount to our \$16 fair value estimate, and we believe the firm has the right strategy to capture more share in the midrange storage market.

A secondary effect of the growth of mobile devices is the increase in demand for flash memory. Devices like the iPhone and iPad consume large amounts of flash and have absorbed much of the excess production capacity that the semiconductor industry built during the 2005-07 boom. With flash demand starting to outstrip supply, semiconductor manufacturers are increasing their capital spending plans to add more production capacity. We recently compiled the capital

spending budgets for 17 top semiconductor manufacturers. Total capital spending for these firms is set to increase 86% to \$33 billion this year. This bodes well for our 5-star names in the semiconductor equipment industry, Applied Materials AMAT, KLA-Tencor KLAC, and ATMI ATMI.

Top Technology & Telecom Sector Picks

Company	Star Rating	Fair Value Estimate (USD)	Economic Moat™	Fair Value Uncertainty	Consider Buying
Applied Materials	★★★★★	22.00	Wide	Medium	15.40
KLA-Tencor	★★★★★	45.00	Wide	Medium	31.50
ATMI	★★★★★	27.00	Narrow	Medium	18.90
France Telecom	★★★★★	35.00	Narrow	Medium	24.50
Qualcomm	★★★★	49.00	Wide	Medium	34.30

Data as of 6-24-10.

Applied Materials AMAT

Applied Materials is the biggest player in the semiconductor equipment industry. Its immense scale and resources allow Applied to compete effectively with a broad product portfolio against smaller chip equipment makers that tend to focus on specific segments of the market.

KLA-Tencor KLAC

KLA-Tencor is one of our favorite companies in the semiconductor equipment space. The firm is the dominant supplier of process diagnostic and control (PDC) tools, which are used by chipmakers to detect defects and maximize yields during the semiconductor fabrication process.

ATMI ATMI

ATMI is a leading provider of materials that are used by chipmakers during the semiconductor fabrication process. We believe that the firm has better growth prospects than the typical supplier to the chip industry, as materials play an increasingly critical role in helping drive Moore's Law over time.

France Telecom FTE

France Telecom is the wireless leader in France, one of our favorite wireless markets. Competition is relatively benign, and the other two operators are divisions of much larger conglomerates. In addition, investments in emerging markets, particularly Africa, still provide opportunities for the wireless business to grow. FT now has 35.4 million subscribers in 14 African countries.

Qualcomm QCOM

Qualcomm's intellectual property surrounding code division multiple access (CDMA) wireless standards is unparalleled and positions the firm to reap generous windfalls from the progression to 3G and 4G wireless technologies.

Toan Tran does not own shares in any of the securities mentioned above.