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## THE TEXAS HEDGE REPORT

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### **INTEL – GOOD COMPANY, BAD INVESTMENT**

Stock Price - \$34.10

Market Cap - \$223 billion

*Note: we do not believe that individuals should sell-short individual stocks, because shorting is just too risky. The best advice we can give is to not own any of the large cap semiconductor stocks, particularly Intel, because they are horrendously overvalued as we will explain below.*

The largest member of the SOX (Philadelphia Semiconductor Index) at 20% of the index is Intel. Intel is a microprocessor juggernaut that has become ridiculously overpriced and whose business is starting to fray at the edges. You need at least two elements for a short 1) absurd valuation 2) weakening fundamentals as a catalyst for others to notice the absurdity of the valuation. In a perfect world, knowing that management was dirty would be the third piece of the puzzle, but that just isn't the case here (management are not realists, but we think they are honest people - a scan of the company's proxy filing was clean). Nonetheless, Intel is still a great short at these prices as the stock is worth about \$10 bucks a share.

Normally, we attack a proposed equity position (long or short) by first reviewing the company's leverage if they have any debt. You can't go long the existing equity if the balance sheet is in dire shape. And if the balance sheet is in real shambles, the short becomes more compelling (i.e. Tyco or Enron). Intel has \$14 billion in net cash, so saying we are more than comfortable with their balance sheet and credit is no big surprise. Now, let's talk about the crux of why we think Intel's shares will plunge.

Intel's revenues have ranged between \$25 billion to \$33.7 billion since 1997. The peak was \$33.7 billion in 2000. 2002 revenues registered \$26.8 billion and \$30 billion is likely in 2003. In the early to mid 90s Intel consistently traded at 1-3x sales and 10-15x earnings. Conceptually, this makes sense given the 7-10% earnings yield it implies and the strong growth rate had Intel over that time period.

Today with nowhere near the long-term prospects for growth, the market has seen fit to bid up Intel to levels not seen in its best years of growth. The absurdity is all the more remarkable when one considers that more than 80% of revenues and all of Intel's operating profits come from the extremely mature PC/server business. Much is made of Intel's diversification away from computer processors but given that about \$25 billion of sales come from PCs and servers it is clear that for the foreseeable future that Intel is a PC/server company and buying it for any other reason is ill-advised.



You can buy Intel because you like its PC/server business. The question then becomes why in world would you do so at 7.3x EV/sales?

Intel has about an 80% share of the PC market down from a peak of 90%. After 20 years of floundering, AMD now has a competitive (most would say better) product in the high-end processor space with their Hammer/Opteron line. AMD has an ugly balance sheet, but one that is good enough to survive. Thanks to a massive convertible bond AMD issued last year, the company now has \$1.08 billion in cash (\$950 million net of accrued restructuring) and a operational burn of less than \$100 million a quarter, which we believe is more than ample liquidity for the next year or so as AMD rights itself.

Four or five years ago the "Intel Inside" meant something. We now own two AMD Athlons and had to double-check to even be sure if they were AMDs or Intels. With the absence of any type of killer app (like processor crunching software), we have witnessed the collapse of computer prices as ASPs descend to record levels (quick stat: from 1997 to 2003 average PC prices have fallen to \$1175 from \$1972 - that is a 40% drop). That type of total PC price compression leads to margin compression for all suppliers with the exception of Microsoft. Low end PCs have become the mainstream PCs purchased. Consumers and corporations don't need the latest 3 GHz processor to run Word and Excel. The PC life cycle is getting longer and now AMD has chips at every price point that are as good as, if not better, than Intel's. The Intel brand is under-attack like we have never seen before, making its near record high sales multiple all the more remarkable given the impossibility of growing revenues at much beyond 8-10% long-term.

Most major PC makers have announced the acceptance of AMD Hammer/Opteron products. The lone holdout remains Dell. Dell will likely announce an AMD line at some point as well. Another long-term problem is the concentrating customer base of Intel. It used be that Intel could dictate prices to the myriad of small PC makers. Thanks to the tough times in the PC industry the makers are consolidating and now behemoths such as Dell, HPQ, and IBM control about 40% share. The big 3 gain share each year as the commoditization of PCs drives the smaller players out of business. Intel will have a harder time dictating pricing to a select few customers. Plus, the big PC makers now have AMD as a viable competitor to Intel to bargain for better prices. Intel will not return to its glory days of 70% annual gross margins and they will be hard pressed to keep their current 50-60% gross margins going forward.

A myth we often hear perpetuated is that Intel could wipe AMD off the face of the earth if it wanted to. While from a numbers perspective Intel could probably cut ASPs and run AMD out of cash, we consider this very unlikely for two reasons. The first reason being that Intel would have to kill its margin for a year or so to do it. While that might accomplish a restructuring of AMD it would almost certainly wreck Intel's multiple in the process. The second more compelling reason why Intel can't run AMD into the ground is because of antitrust. Intel on the PC side has no real competition besides AMD. Should they run AMD into bankruptcy, a Microsoft type situation of legal nightmares could emerge.

A detailed free cash flow analysis is the final nail in the coffin for Intel. Intel currently trades 20x its top of the bubble net income of \$10 billion. It trades for 30x the high end Street estimates of a buck a share in 2003. But both measures are artificially low because they fail to account for stock options. Options



are a constant headwind against most tech companies. Years of doling them out like candy has created massive annual dilution that forces the company to make more money each year just to grow earnings per share with the rising share count or, as is the case with the behemoths with limited growth prospects like Intel, companies must buyback an enormous amount of shares to keep the share count flat and EPS growing.

The 2000-2002 timeframe provides an interesting glimpse into Intel's free cash flow. 2000 was a very good year, 2001 was a poor year, and 2002 was mediocre year, which gives a wide range from which to judge free cash. During the 3 years, Intel averaged \$10 billion in operating cash flow. Intel capexed an average of \$6 billion per annum in those 3 years. That yields \$4 billion in traditional free cash flow per annum. The cost of stock option dilution is not captured in that free cash flow figure. Each year the \$4 billion of free cash must be spread across a larger number of shares causing free cash flow per share to decline. Intel realizes this dilution and accordingly buys back enough stock to keep its basic share count flat. This consumes \$2.7 billion annually and leaves true free cash flow of about \$1.3 billion a year. A \$200 billion EV means that Intel trades at about 150x trailing average 3 yr free cash flow. Gulp.

To be fair, Intel could earn \$1.00 in EPS going forward. That translates into \$6.8 billion before required stock repurchases to maintain a flat share count. Subtracting the \$2.7 billion in annual outflows for that activity leaves \$4.1 billion in true free cash flow/net income. Intel trades for about 50x times the Street's optimistic free cash flow calculation. That is a 2% free cash flow yield versus the 4.1% now offered in 10-yr risk free rate. Tough choice.

It is not like we have always hated Intel. It was one of our largest holdings personally in the early to mid 90s, but things were different then. The company traded at 1-3x sales and was growing like a weed (25-30% a year on the top-line, sometimes much more on the bottom-line). More importantly, we would go home every night and be frustrated with our painfully slow 386x and 486x processor that couldn't even run Microsoft Office. Most of our friends were the same way. On all of their wish lists was a faster computer and at that time Intel was emerging as the clear leader in supplying microprocessors to all these new computers. A massive upgrade cycle that Intel would be a primary beneficiary of was coming.

Today, 78% of U.S. households have at least one PC and many of those holdouts are the elderly who aren't getting PCs despite all the prodding in the world. Intel now has \$27-30 billion in stagnant revenues and it trades at over 7x sales! Plus, the business is fraying at the edges from competition by AMD and a consolidating supplier base. Oh, and the 2<sup>nd</sup> half of 2003 consumption binge of PCs simply drew forward demand as the consumer used tax rebates to keep buying. We suspect 2004 will be much a more difficult environment for PC/server sales.

If you own Intel here at 34 bucks and change, we believe you are going to lose money a year from now, and if you are short it you should make money if you commit to the short for a year. Intel is worth \$10 bucks or so ((2x \$30 billion in sales + \$14 billion in net cash)/6.8 billion shares). We will re-evaluate when it gets closer to \$10 bucks.



**Intel Appendix – Behind the Math – Helping Investors Evaluate a Tech Company’s Free Cash Flow**

In an adjusted free cash flow calculation we make our best estimation to account for stock option dilution via the annual share repurchases INTC is required to make to stem option dilution. This repurchase along with a few other items (trading asset purchases that must be stripped out as it unfairly penalizes free cash flow and add back cash received from options exercises) serve as a good proxy for the true free cash flow of the enterprise, which is not captured in traditional cash flow calculations.

Adjusted Free Cash Flow Calculation is made as follows:

CFOPS
- CAPEX
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<b>TRADITIONAL FREE CASH FLOW</b>
+/- TRADING ASSETS (in CFOPS, but shouldn't be as it is investing cash flow)
+ CASH PROCEEDS FROM STOCK OPTION EXERCISES
- CASH USED FOR STOCK REPURCHASES
+/- EXTRA (DEFICIENT) STOCK REPURCHASES TO KEEP BASIC SHARES OUTSTANDING FLAT
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<b>ADJUSTED FREE CASH FLOW</b>

As one might guess, when we look at INTC's true cash compensation expense the trailing P/E based on Adjusted FCF instead of "E" soars to near 50x. A 2-5% FCF yield is the best you can hope for Intel at current prices. Given INTC's limited growth prospects, the stock seems very rich.

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