Sand Spring Advisors LLC

Failed Accounting Standards,

Mmm, Mmm, Good,

and Where (if at all) to Invest in Bandwidth

By,

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The Value Line Index creeps higher out of its multi-month coil. The NYA average pokes its head to new highs. Both of these developments are bullish stocks. But the NASDAQ and particularly the Internet sector – both previous market leaders -- continue to struggle well below their March highs. Meanwhile, a few high-tech high-cap darlings such as Apple and IBM are starting to stutter and stumble, while most Internet stocks trade at a 50-80% haircut to their all-time highs just a few months ago, and on an ongoing basis, are now acting like toxic waste.

It is almost as if slowly day by day, some sense of rationality is starting to reassert itself back into the equity market. Value situations are suddenly takeover plays, one of the hottest takeover sectors having recently been the otherwise boring and beaten-down consumer foods stocks.

Unfortunately, we have no immediate vision on which of the various broader averages will eventually come to dominate the overall trend, nor how to astutely forecast the next overall "market" move. Everything has simply become too bifurcated for a great deal of confidence in making a definitive prognostication.

We know that cyclically December 26, 1999 represented a momentum high for the Dow Jones and many individual stocks, and our last cycle date May 5, 2000 represented an acceleration lower preceding the current substantive June-July bounce. We also know that the next important cycle period is between September 13-21, 2000. September 13 specifically will represent 2.15 years from the July 20, 1998 high and one-quarter of the 8.6 year Princeton Economic Confidence Interval. It is preceded the week of September 4th by a Princeton Economic Institute "panic cycle" in both the S&P and Dow Jones. If these markets are rallying into this period, it ironically could result in a very bearish set-up where an apparent bull market suddenly rolls over and dies. A far more constructive path would actually be to trade down into this time-window and then burst higher out of it.

With the caveat that amidst all the noise, the strength of our conviction is limited, the path we are happiest envisioning would continue to be a grope higher into early September with the NYA and Value Line indices leading the way, with the September 4th panic cycle in the S&P and Dow Jones marking an "outside reversal" top. The week of September 13th would then be set up to begin the next leg of a bear market – something that in Elliott Wave terms could be the III wave down – a period when the light bulb finally goes on in most peoples' minds that "gee, this really is a bear market." The current NASDAQ could still easily end up looking somewhat analogous to the Nikkei chart of 1990 (shown as an inset below) – when after a first leg down, and a two-month bounce, prices finally rolled over and fell off a cliff.

Rather than push a definitive interpretation at this time, however, we thought it better once again to share with our readers three areas of discussion we feel more comfortable and confident presenting. The areas could not be more different, so we offer them below as three distinct discussions: (1) What is happening to the accounting standards of America? – many varied examples of abuse; (2) Left at the alter in the Best Foods deal, what is to become of Campbell Soup; and (3) If you insist on investing in a Bandwidth play, where to do it with the least risk.

Accounting Standards

It is hard to decide which is a scarier development: an investing public that no longer delves deeply into company balance sheets and accounting practices, or on the other hand, accounting practices that themselves are so lax as to make the profit and loss statements of many major companies near useless. Here we wish to share with you the words of tech fund manager Andy Kessler of Palo Alto-based Velocity

Capital Management LLC. Mr. Kessler, who occasionally writes a column for the *Wall Street Journal*, recently penned an article that is a must-read. Since we are not sure if it has already appeared publicly, we present it to you in its entirety below. It is entitled:

Oscar Mayer Accounting

The key to capitalism is the stock market, and the key to the stock market is disclosure. As investors, we have an unwritten contract with management that says: you run the company, you pay yourselves fat salaries and options, you stock the bar at the ski chalet in Aspen, just tell us how you are doing every once in a while. Listings on exchanges like NYSE or NASDAQ further requires honest reporting, what is known as GAAP or generally accepted accounting principles. Beware of what is generally accepted.

I am more than happy to pay up today for my belief in extended growth and the long term model of a company. Losses are fine if they really are investments and help build a big valuable company. Just show me a model that scales and I'll remain loyal.

Management loves a high stock price, not only for personal greed, but also for currency to buy things money can't buy, and to keep themselves un-acquirable for job security. The long term model drives lofty valuations, and each quarters earnings release gives subtle clues as to whether we are on target or not.

But I quickly tire of companies trying to game the Street and paint a different picture than what is real. Quarterly reports are doctored in that "no controlling legal authority" sort of way. The public is fed each quarter's financial results with what is known as a baloney sandwich, "you know what's on the top, you know what's on the bottom, but it's just a lot of baloney in the middle."

It used to be so easy, extended receivables, mispriced inventory, shipping bricks, but the new economy requires new tricks. When I catch a lie, I never trust a company again. If their business is not apparent and books not transparent, I'm gone, before Adam Smith's not so invisible hand slaps me silly with a stock implosion.

Here are five tricks that fall between chicanery and tomfoolery (two words that I've always wanted to use).

Empty COGS

Marketing expenses at Internet companies are assumed to be the costs of TV ads and billboards. Think again. Marketing is considered discretionary, as investors think you have a great business that "just needs to be grown into." Hardly. CD Now is famous for sending $10 off your next $10 purchase a week before the end of the quarter. Whatever you bought was recognized as sales, the $10 off as marketing expenses. Free shipping, also a marketing expense. No scale here.

When you buy a book at Amazon.com, there are fulfillment costs with each order that are not discretionary and just won't go away. To quote Amazon's latest 10-K:

Fulfillment costs included in marketing and sales expenses represent those costs incurred in operating and staffing distribution and customer service centers, including costs attributable to receiving, inspecting and warehousing inventories; picking, packaging and preparing customers' orders for shipment; and responding to inquiries from customers.

Hmm, sounds cost of goods-ish to me. These are not tiny numbers; $188 million out of the $413 million in marketing expenses in 1999 were for fulfillment. Gross profit was only $290 million. If fulfillment had really been considered cost of goods, gross margin would have been 6.2% vs. the reported 17.7%. Similarly, Priceline counts credit card processing fees as a marketing expense. Slim gross margins and non-discretionary expenses, a lethal combination.

Laundering the sheets

Since many companies raised tons of money in their IPO, the temptation to turn the cash on the balance sheet into sales is overwhelming. Sure, you can sell below cost, but that takes too long. Why not give someone else the money and have them turn around and buy something from you. Amazon announced a deal with drugstore.com, exchanging $30 million in borrowed money from Amazon's balance sheet in exchange for equity at $28, (DSCM is now $7, which is down the same river AMZN is headed.) But tied to that deal was a sponsorship arrangement whereby drugstore would pay Amazon $27 million up front and $105 million over 3 years for a health and beauty tab on Amazon's home page. Do they sell laundry detergent from that tab?

Similarly, Microsoft invested $250 million in Healtheon/WebMD, and guaranteed them another $150 million in revenue to, in part, subside thousands of physicians $29.95 payments for Internet access. Whose Internet access? Well, Microsoft's MSN. Voila, cash on the balance sheet into sales, it sounds unhealthy to me.

Tweaking knobs

Sales are sales, right? Well, sort of. Every CFO loves to have a little play with the reported numbers, a knob to tweak so as to adjust, to smooth, and to move things around. One I call the Fram oil filter knob: Take revenue now or take revenue later? It is a sure sign of imminent trouble. Close a customer for a three-year deal to use your software or service, but then report all that revenue now. The more GAAPable approach is to put the cash on your balance sheet, have an offsetting liability called deferred revenue and then reporting revenues of 1/36th per month over the life of the deal. Temptation is too much. Data mining company Microstrategy lost 90% of its value when they got caught taking it all up front and had to restate earnings, as investors had no idea what was real recurring revenue vs. big contracts.

Other companies who have lumpy businesses from big one time increases in sales, say a new software product or operating system launch, very often save a lot of those sales for future quarters by deliberately putting them into deferred revenue, where perhaps they don't belong. This helps cover errors and missed quarters later. Microsoft is still unwinding deferred sales of Windows 98 to cover Windows 2000's delay and ho-hum reception. Investors are now discounting these deferred sales; they should have just reported them honestly. Companies like e.piphany try to game the Street by claiming their accounting conservatism, but instead may be a time bomb if their growth slows and they unwind deferred sales instead of generating enough new ones in a future quarter. It is always easier to explain away honesty than recover from a cover up.

Beefed up

Priceline.com matches wannabe fliers with distressed (i.e. empty) airline seats. To investors, they report the full value of the airline ticket, almost as if they were flying the plane. Their claim is that they actually own the ticket, and are "the merchant of record" (if only for a few nanoseconds) and are actually liable vs. merely acting as a commission-collecting agent. Yeah right. You think William Shatner will beam me to NY next time my flight gets canceled?

Ebay on the other hand, reports just their "commission." In effect, Priceline overstates their revenue by a factor of 6-7 or so. DoubleClick, more or less an old line advertising agency in a new medium, reports advertising billings as revenue instead of just the 25% commission, by claiming they operate a network that accepted ads, rather than placed ads on a network. Their customers call them fees. These semantics ups their sales by a factor of 4.

In the early '90's, I met the management of Itochu, a Japanese trading company. They boasted to being one of the world's largest companies, with over $100 billion in sales. Turns out they did that in trade, got barely a 5% fee on the goods they traded, so were really a five billion sales company. Should we consider the NYSE a $100 trillion company because of the value of the shares they trade? Hardly.

Barter Fodder

At least smart investors could back out the real sales from the grossed up sales. IVillage and StarMedia and many other portal companies, to meet Wall Street's growth demands, do 10-25% of revenues in barter. A company would exchange, say $1 million in banner ads on their site with some other dotcom for $1 million in ads on the other site. This can take place on June 39th, when you know how much you need to beat investor's expectations.

No money changes hands, just banner ads that have zero cost. Both companies get $2 million in extra revenue, and records $2 million in marketing expenses. While there may be some economic benefit of this barter, perhaps some new traffic, the accounting is suspect. And who values these ads? Why not report $20 million in barter revenue, and really beat Wall Street estimates. Heck, do a barter deal with Itochu and report $20 billion in revenues.

I'm just getting started. Add paying employees with options, funny user counts, merger accounting, capitalizing subscriber acquisition costs. My accounting has a first name, it's O-S-C-A-R...

All we can say of Mr. Kessler's article is the French expression: *Bien dit!* (Well said!)

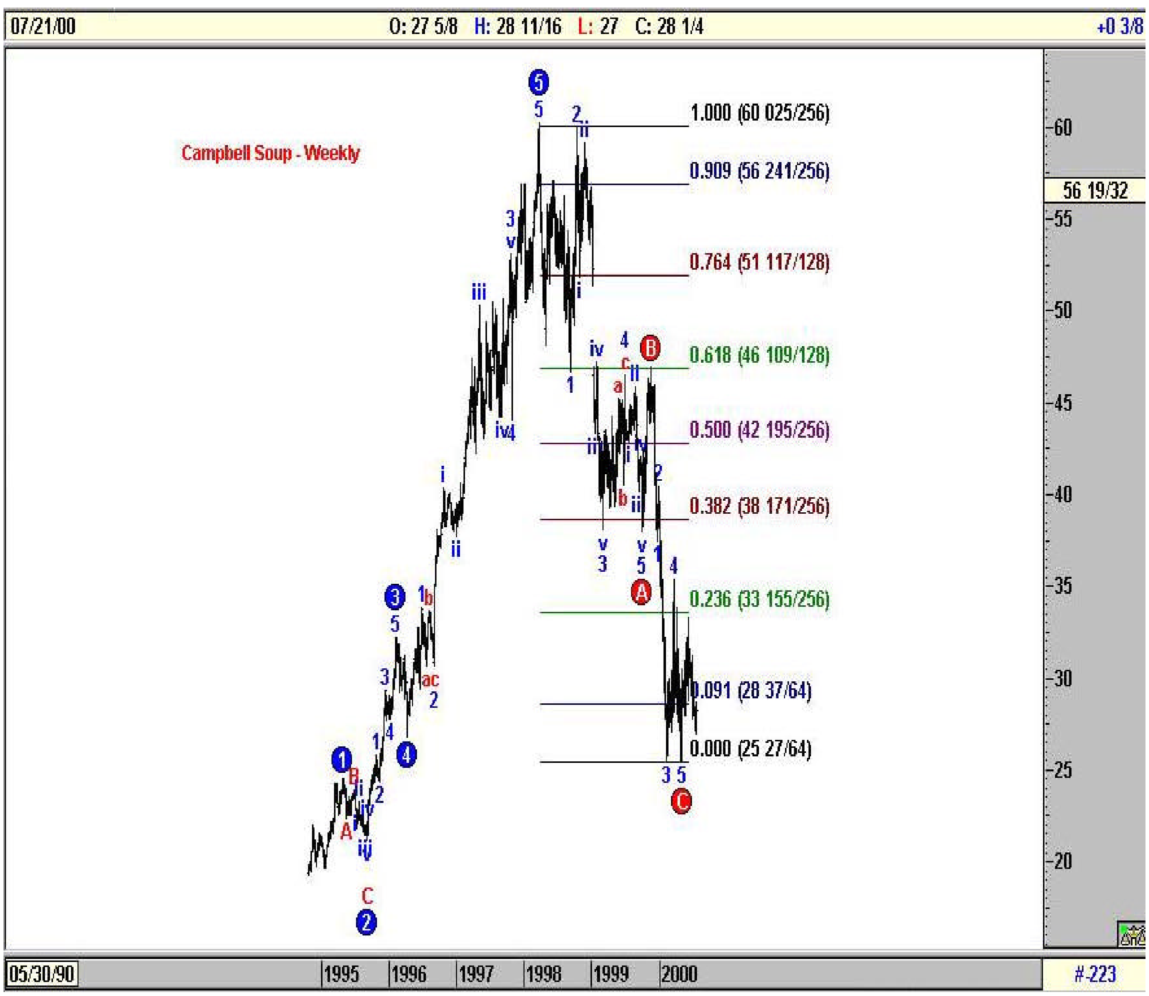
Perhaps if we ourselves had paid closer attention to fraudulent accounting and representations by management of one Philadelphia insurance company: Reliance, featured on these pages previously, we would not have been tempted to buy it on technical grounds at 5 3/8 just to get stopped at 4 ½, and then to get re-tempted to bottom pick at 1 ½ as the stock now quickly approaches 0. In that instance, management issued materially false and misleading information concerning, among other things, the company's expectations of recovery on its reinsurance contracts.

All of the Kessler's above-mentioned accounting tomfoolery may seem less serious than the Reliance situation, but these types of practices will likely end in similar tears.

<u>Mmm, Mmm Good</u>

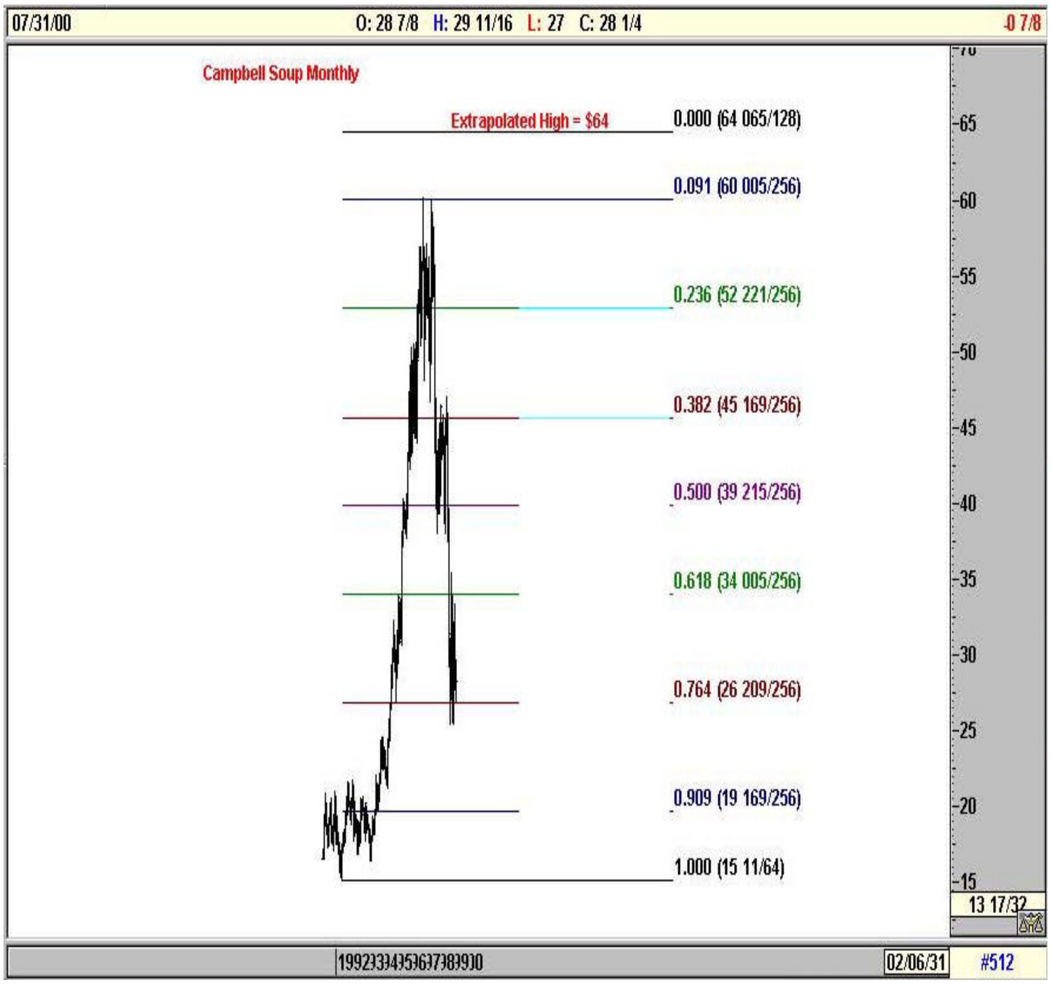
So where should one invest amidst all the hype and accounting gimmickry? The answer may be in one old-world company that has avoided most of it: Campbell Soup. As mentioned previously, we are currently in the midst of a takeover frenzy in U.S. consumer food stocks. Nabisco Holding just got taken over at a nifty P/E of 38, Best Foods got purchased for a P/E above 28, General Mills bought out Pillsbury at a premium price, and most recently, Keebler put itself up for sale and is currently trading at a P/E above 37. This makes us feel on a fundamental basis Campbell Soup with its fine Pepperidge Farm, V-8, and Campbell brand names must be something of a steal at 16.5 times earnings.

Technically, we also like the look and feel of the Fibonacci rhythm depicted below. From the 1999 high, pulled lower, the Fibonacci bands "fit" the price action nicely to our recent lows. Although we might take issue with a few of the lesser-Elliott wave labelings generated by the GET computer system, overall we would concur that the recent decent appears to be a large A-B-C corrective affair that should likely leave another impulsive move higher.



If Campbell Soup were to be taken over, what might it fetch?

Pulling Fibonacci retracement bands in the other direction – up from the mid-1992 low, we can easily extrapolate a $64 a share price target for a 5th wave advance.



We would however suggest a stop at just under $24 to protect oneself. $24 ½ represents the high of the early 1995 advance and ideally that high should not be intersected. If it is, we'd let our stop send us to the exit door, and go on to the next trade.

The technical picture of Campbell Soup is the cleanest looking to us among the food stocks, but there are also other interesting low P/E situations one might also consider: Del Monte and Libbys.

On a poor earnings forecast, Del Monte recently fell to just 4x earnings. The stock is 47% owned by the Texas Pacific Group and one must feel that that group will want to improve upon this stock's dismal performance -- perhaps by accepting or arranging a buy-out transaction.

Del Monte Weekly

Chart courtesy of BigCharts.com

Libby's, another piece of Americana, is also trading at just 11.5x earnings, even after moving nicely higher recently. Although thinly traded, are they in play as well?

Libbys Weekly

We are not stock-pickers by training at Sand Spring Advisors, but we are intrigued by all three of the above pictures because the downside would appear so limited. All of these companies are staple non-cyclical boring affairs, but within an environment where it is suddenly fashionable to consolidate and merge. Each would likely represent a low risk bet to potentially double one's money if a takeover were to come along. And if it does not, the downside is limited. Our risk-reward instincts are intrigued.

Bandwidth

But food stocks aren't sexy enough, you say? Surely there must be some other area of the economy with dynamic growth and huge prospects, and surely there are. One such area is of course the development of improved bandwidth connectivity for the Internet for the burgeoning distribution of audio and video content.

Right now, bandwidth demand is estimated to be doubling every 72 days. Global telecom companies are laying miles and miles of fiber optic cable to meet the anticipated demand. Surely somewhere in that growth there is a huge potential investment opportunity.

Such opportunities do of course exist, but as opposed to the low risk proposition that our food companies represent, this is a high-risk type of area. Companies can come and go in the flash of an eye, their technology state-of-the-art one day, and replaced with a next-generation product the next. One small misstep can prove fatal. Just consider what happened to one company called Star Telecommunications. Their management recognized early that bandwidth demand was going to balloon, so they purchased a great deal of capacity early as well. The only problem is that given various technological advancements, this capacity has now fallen in value to less than a tenth of Star's locked in cost. As one might expect, the stock in Star has fallen as well -- currently trading at just 7% of its 1998 high.

You see, while demand for bandwidth is burgeoning, so too is its supply. Fiber optic cable, unlike natural gas or crude oil, is a commodity that does not get used up. It only gets transited and then eventually replaced by technological advances that are continuous. For example, courtesy of a new technique called "dense division multiplexing," the cost of data passage over fiber networks has been headed lower in spite of the burgeoning Internet demand for bandwidth. "Multiplexing" uses different spectrums of light to allow more than one "bit" of data to pass through a single strand of fiber at the same time. Right now Nortel is up to 32 multiplexed wavelengths passing ten gigabits per second through a fiber strand, and a year from now experts expect 160 multiplexed wavelengths passing 40 gigabits of data per second to be common place. So demand is not only increasing exponentially, but so too is supply. That's what makes this an interesting but complicated marketplace.

Meanwhile, the cost of a rack of telecommunications space to hook networks together at a central hub such as 111 Eighth Avenue or 60 Hudson Street in New York City has never been higher. At present, this type of so-called Co-Location real estate space trades at five to six times the cost of normal office space.

So where amidst all these developments is the best investment likely to be found? For the moment, Corning, the largest manufacturer of fiber-optic cables is the obvious play, but the public is already all over that stock, and its valuation near $300 a share already quite high (albeit likely headed higher). Co-Location space companies are also red-hot, but mostly private.

The public is also enamored with all the telecom companies – the Nortels, the Level-3s, the Sprints, the Nextels etc. But here the enthusiasm is likely a bit misplaced. You see, while most telecom companies will in fact benefit from the growth in bandwidth demand, these companies are already getting killed by the decline in price for traditional "voice minutes." That is why Michael Armstrong at ATT in particular has such a tough job and ATT the stock -- a traditional bell-weather blue-chip that CNBC touted in March as a huge "Internet play" -- has more recently been hitting the skids. Regardless of growth prospects in the Internet, there is no getting around the fact that 70% of ATT and most other telecom companies' revenues still come from traditional telephone minutes billing. But at the now-available 5 cents a minute from New York to London, and other global super-discounted rates, few can make much money. ATT's revenue base is headed down the tubes while they madly scramble to meet analyst earnings estimates through cutting costs – firing staff. It's a bad equation, not a good one.

"This industry is about 12-15 months away from a real profitability crisis," we are told by a voice-minutes expert. Hence, when thinking about a pure bandwidth play, stay away from any company involved in traditional voice connectivity. They are all in for a huge fall from grace, even those with a strong emphasis on cellular.

There are other obvious candidates to invest in: Enron and Williams Communications being two of them, but once again, there is a tremendous amount of hype and excessive valuation already. Just announcing a bandwidth trading platform last year added several billion dollars to Enron's total capitalization, and yet one hears that their huge trading room for the product in Houston remains largely empty, with just a handful of deals going through per month. The PR value of lining up Blockbuster to deliver on-demand video through their backbone capacity may be an important recent development for Enron, but you'll be paying over the top to buy Enron here. Just look at where the stock has come from on the chart below, and how nicely complete its Fibonacci rhythm appears.

We are also told by industry sources that at the end of the day, the real money in bandwidth will not be made by companies that establish a great deal of "backbone" capacity, but by the companies that figure out the so-called "last mile" solution. By this we mean that it is relatively easy already to ship streaming video content between two telecom hubs in New York and Los Angeles. The tricky part is getting it from the respective telecom hub to one's home. The traditional Bell companies are slow, expensive, and not particularly innovative getting this done despite their pre-established local service edge. The companies involved solving this "last mile" provisioning are the ones that are going to take home the bacon. That's where you want to invest.

"Enron recognizes that in the early stages of a market's development, it's a huge advantage to have physical facilities," one industry expert explains to us, "and other companies are all scampering behind them thinking they understand what Enron is up to. The press is all focused on paired city trading because it is something they can conceptually understand. But the interesting thing about all of this is that Enron probably does not expect to make its money on commoditized paired-city trading, but instead on downstream services from these pooling points. The margin isn't in paired-city trading and probably never will be."

Enron is developing a long-haul network to attract those clients initially, but ultimately, Enron will likely use other people's long haul capacity and getting rid of their own. "Just like in oil and gas -- where they ultimately sold Enron Oil & Gas -- they don't need to produce this stuff, but they will make money rebundling it."

What other companies exist in this "last mile" provisioning space already? Unfortunately, the two leading companies here with the best technological solutions to last mile provisioning of bandwidth are still private, but we will mention them here in case they were to ever pop up on one's upcoming IPO page. Terabeam has a technology to allow the wireless transmission of bandwidth over a few hundred yards into one's home at speeds that are truly impressive. Another company, London-based VideoNet, has a technology using ADSL technology to get streaming video into one's home over traditional copper phone lines. All you have to do is hook up a special box to your phone outlet. This last mile solution is already going live in Britain, but hasn't made it to the U.S. yet.

For now, the only public company that we could find specifically oriented and already up and running to solve the "last mile" connectivity problem in the United States is a company called Universal Access (NASDAQ symbol UAXS), the stock of which is pictured below.

Universal Access (UAXS weekly)

Universal Access's clients are primarily other communication service providers, Internet service providers, competitive local exchange carriers, and other application and network service providers. The company can establish local loop connectivity and Internet routing via the many hubs that it is building far faster and cheaper than available from traditional Bell companies themselves.

From its IPO in March, the stock vaulted higher to above $60 a share, collapsed to $14 a share, and currently trades just above $34. It does not have any special technology such as those being developed by Terabeam or VideoNet, but it is a company in the right place at the right time as the demand for better connectivity booms. The company recently inked a deal with long-haul broker Amerex to provide such services to their clients.

Although one must be cognizant that Universal Access needs to keep its technology up to date as products like Terabeam become commercially available, for now, Universal Access should be in a great business at the right time. Like most start-ups – the company is currently hemorrhaging money as they build up their infrastructure capacities and client base, but their revenue bases is also growing at six-fold a year.

Amidst a lot of other hype and disappointment out there, UAXS might just be a company to keep one's eye on.

Send us your comments at info@Sandspring.com.

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