Portfolio Profits Boost Bottom Line, But Stir Controversy for Some Firms

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Happily tallying up your profits on the stock of Microsoft and Intel? They're nothing compared with what Microsoft and Intel are earning on their stock investments.

The companies' profits from investments -- which are entirely separate from their operating income -- are eye-popping: Intel recently booked $327 million in quarterly earnings from sales of stock it owns. Microsoft, in its latest quarterly report, had $773 million in profits from selling such investments.

It isn't just technology companies that are making lots of money in the stock market: General Electric Co. and Delta Air Lines, among others, are making significant investments in other companies, often venture-stage enterprises, then sometimes realizing nice gains when the stocks of those companies climb. To the extent the stocks are sold and the gains realized, they flow to the companies' bottom lines.

While supercharging the profits of some big U.S. companies, these stock-sale profits raise an interesting -- and to some a troubling -- question: Are stock prices themselves giving a significant boost to the very profits that are fueling the euphoric stock market? Or, put another way, are stocks to some extent feeding on themselves rather than on real growth in their businesses?

That is the worry of some market watchers who analyze company earnings. The contribution these investments make to some companies' earnings may be difficult to repeat, they note, and may mask the quality of the underlying business. And if the stock market were to correct sharply and the market for hot initial public offerings cool off, many of those gains would dry up or perhaps even turn to losses.

"If the companies' earnings growth is not coming from normal recurring operating activity, the infrastructure is weak and a high stock price is not going to be sustained," says Howard Schilit, president of a for-profit group called the Center for Financial Research and Analysis. "What a healthy business is all about is having a core business producing an increasingly larger client base ..., not one where the revenue flattens out, margins contract, but the company happened to luck out" on its investments.

Of course, even companies booking big gains on investments still get the majority of their gains from producing things or providing services. Moreover, their investments often complement their core business operations, because larger companies can get valuable insight and strategic advantage through a close relationship with young, dynamic companies. In any case, U.S. companies are still far less likely to have significant stakes in other enterprises than their Japanese counterparts.
Purpose of Investments

But with companies pouring growing amounts of money into start-up companies, analysts say it is becoming increasingly difficult to tell whether these investments are motivated more by strategic reasons or by the hope of stock returns. "More and more, the returns seem to be the objective," says John Taylor, chairman of the National Venture Capital Association. "One thing we're seeing a lot more of is companies co-investing with traditional joint venture-capital firms in deals that are very much returns-oriented."

The companies themselves extol the strategic benefits of their investments, while affirming they very much want them to be profitable. Intel Corp.'s $327 million gain from sales of investment shares boosted its net income to $2.4 billion and enabled it to beat Wall Street estimates for the quarter; and Intel shares jumped about 13% last Friday on that earnings report. But Chief Financial Officer Andy Bryant says the investments aren't made for purely financial reasons. Intel makes investments in companies that "provide strategic benefits" such as accelerating a new technology or market, he says.

SmithKline Beecham PLC's $100 million Philadelphia-based venture-capital fund, S.R. One Ltd., holds investments in about 47 firms, almost all made in conjunction with one or more traditional venture-capital investors. "That's because we invest for the same reasons that they do: for return," says Brenda Gavin, a partner at the fund. "The only difference is that we'll invest only in companies that are of strategic interest to us."

Microsoft Portfolio

The precise value of corporate America's holdings of equity in other companies isn't known, but it appears to be growing. Microsoft Corp.'s portfolio totals $19.8 billion. Intel's totals $8 billion. Compaq Computer Corp.'s investment portfolio, counting only publicly traded stocks, is $8.3 billion. Such sums include stakes in both established companies, such as Microsoft's holdings in AT&T Corp. and Comcast Corp., and many smaller, sometimes private companies.

Indeed, corporate investors are an increasingly important presence in funding early-stage start-ups. They accounted for as much as 16.3% of the roughly $43 billion funneled into in venture investments in 1999, compared with 7.5% of the $20 billion invested in 1998, according to the National Venture Capital Association.

Not surprisingly, given the rampaging bull market, these investments are making a growing contribution to some companies' earnings. Normally that happens only when the companies sell the appreciated stocks. But other stocks owned by a corporation can benefit its bottom line even if they aren't sold; that happens when a pension fund gets such a lift from rising stocks that the company is able to book a profit instead of a pension expense.

The past week has seen much evidence of these equity stakes, including Microsoft's report on Tuesday for its fiscal second quarter. Microsoft's increased investment income contributed about four cents to the company's 47 cents a share of net income (excluding a charge), and it supplied most of the "upside surprise," that is, the amount by which Microsoft beat Wall Street's 42 cents-a-share consensus estimate.

Delta Air Lines Wednesday reported a pretax $596 million gain from the sale of a portion of its stake in Internet ticket-seller Priceline.com and other investments. Including that gain, Delta's quarterly net earnings came to $352 million.

And just Wednesday, America Online reported a pretax gain of $111 million on an investment in Sandpiper Networks. AOL's profit after taxes, one-time gains and charges totaled $271 million.
Robert Willens, a tax and accounting analyst at Lehman Brothers, says investors tend to ignore gains and losses on equity stakes when evaluating a stock. "I don't think people are being misled by those gains. I think the analysts are doing a real good job of calling people's attention to that," he says.

Indeed, investors looked through Microsoft's strong earnings to signs of weaker revenue growth and sent its stock down $8.3125 to $107 in Nasdaq Stock Market regular trading Wednesday. That accounted for most of the 71.36-point drop in the Dow Jones Industrial Average to 11489.36.

But in some cases, investors need to consider whether to regard companies as strictly operating companies or as some hybrid of operating company and investment fund, akin to Berkshire Hathaway Inc., which owns minority stakes in public companies but also has full ownership of insurance and other operating companies.

Big portfolio gains are nothing new to Microsoft. Its new chief financial officer, John Connors, says that while analysts shouldn't stop viewing Microsoft as an operating rather than a portfolio company, gains from investment are likely to recur, given the robust stock market and Microsoft's huge portfolio of holdings. That portfolio has quadrupled in value since September 1998.

While Intel's Mr. Bryant says the company has been selling some positions quarter-by-quarter for three years, the size of the portfolio -- which employs more than 100 people scouring the globe for technology investments -- and the related gains now are so large, Intel will hold regular monthly reviews of holdings.

But he also says Intel won't use its investment activity to smooth earnings and meet Wall Street estimates. "We're not sitting here trying to predict the market," he says. "All we're doing is setting up a periodic program to bring some of the value back to the corporation."

Compaq is about to more explicitly recognize its investment activities. Chief Executive Michael D. Capellas says Compaq will soon break the investment unit out of its strategy and technology unit, making it a separate profit-and-loss division. "It's 20% of the capitalization of the company," Mr. Capellas says. It has certainly been a profitable unit. The value of Compaq's stake in the AltaVista Internet search engine could ultimately approach the $9 billion Compaq paid in 1998 for its creator, former computer giant Digital Equipment Corp. Compaq also has stakes in hot start-ups such as Ask Jeeves Inc., NetZero Inc., Roadrunner Inc., and Internet Capital Group.

Further diverging from the portfolio's original purpose, Mr. Capellas says he no longer will restrict new investments to companies or technologies that directly benefit Compaq's computer business. "We are in the business of predicting where technology is going. So we are picking winners and losers," he says.

But such talk might give pause to investors, who generally base their opinion of a stock on how the company's core business is doing. In one sign of the shift, Wall Street earnings estimates for Intel now incorporate stock sales. "If the market deteriorates, Intel's earnings will as well. Intel's earnings are dependent on the continued strong performance of the stock market," says Drew Peck, an analyst at S.G. Cowen Securities. "We have never seen its value attached to the stock market. We're in a world of New Age accounting that raises the risk level."

It's not just technology companies where this is an issue. Chase Manhattan Corp.'s Chase Capital Partners, which has stakes in newly public companies such as Cobalt Networks Inc. and Digital Island Inc., realized investment gains of $1.31 billion in the fourth quarter, up from $244 million in the year-earlier period. That helped the bank easily beat profit estimates Wednesday.

San Francisco-based Wells Fargo, which merged with Minneapolis-based Norwest Corp. in November 1998, saw its noninterest income soar 33% in the most recent quarter, thanks to a $560 million gain recorded by its
venture capital division on the sale of Cerent Corp. to Cisco.

Last year, General Electric's venture arm, GE Equity, invested $1.5 billion, nearly three times the 1998 tally, much of that in Internet and e-commerce firms. While its equity arm has been key in helping GE learn more about the Internet culture, it also has been a solid profit contributor, although GE doesn't break it out.

What worries some analysts is that investors may get used to the contribution from these equity investments, then have a rude awakening if the stock market falls and operations aren't strong enough to pick up the slack. David Tice, president of an advisory firm and fund manager bearing his name, cites the example of Coca-Cola. Coke "hasn't had that great sales growth for some time, but they generated 20% earnings growth by selling bottlers, so people got used to 20% earnings growth," he says. "When they are unable to continue to generate those gains on sales, suddenly investors wake up and say, 'Gee, this company is hardly growing at all.'" Coke's stock is about 25% below its mid-1998 peak.

Coke has previously said that since it constantly invested in bottling assets and then would sell them at the appropriate time, those gains should be viewed as just another income stream, much like selling concentrate. It dropped that explanation after analysts protested.

Similar concerns surround some older companies whose employee pension funds have enjoyed enormous gains from their stockholdings, often enabling the companies to book pension income instead of expense in their income statements. A Bear Stearns Cos. analysis last fall found that 124 of the companies in the Standard & Poor's 500-stock index had such gains in 1998, and that without them, profits for the S&P 500 would have been 3% lower.

Mr. Schilit of the Center for Financial Research and Analysis says Lucent Technologies Inc., for example, got 11% of fiscal 1999's operating income from pension income. He doesn't fault Lucent for the good fortune to have sizable pension income, but says investors have to be aware that such income can mask problems in the underlying business. Lucent's stock nose-dived earlier in January when the company said its coming quarterly profit report would be well short of estimates because of problems meeting customer demand for certain products.

Lucent spokesman Bill Price says that by any measure, "we have conservative accounting practices, and we focus on our core businesses to help us grow revenues and earnings."

An interesting example is Comdisco Inc. of Rosemont, Ill. The leasing company 13 years ago started taking shares in small start-ups. On Dec. 22, Comdisco surprised Wall Street with an unusual disclosure: Its quarterly earnings would be 40% higher than consensus estimates because of gains from the sale of some stockholdings. The company has a portfolio of small stakes in about 430 companies.

Comdisco shares skyrocketed after an analyst concluded unrecognized gains could be as high as $2 billion. But both the company and Wall Street think the market might feel even better about the company if the investments were broken off.

"We on the analytical side weren't going to value this as being profits from continuing operations," says John B. Jones Jr., an analyst at Salomon Smith Barney in San Francisco. Comdisco CEO Nicholas K. Pontikes says the company expects to break out results of its venture operation and create a "tracking stock" to reflect the gains.

Yet Lehman's Mr. Willens, for one, suggests that "there's not a fine distinction between investment gains and operating income, where the investments are motivated more by strategic business reasons. I would argue the investment gains should be considered operating income ... because the those investments are also ways to gain
access to new technologies."

For stock-market investors, nasty surprises could be in store if the types of income are mingled, warns Mr. Schilit of the Center for Financial Research and Analysis. "If you're starting to see a sizable portion of the income coming from selling investments, that is clearly a weaker profile" for a company, he says. Then, to some extent, "you're at the whim of the stock market."

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