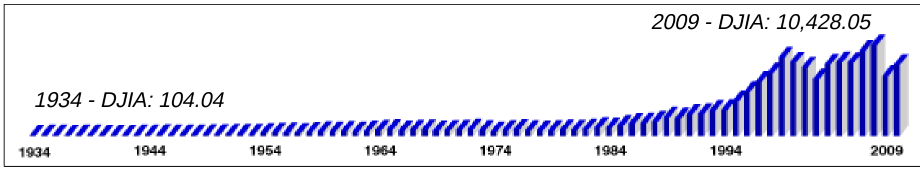
ARGUS®
Independent Equity Research Since 1934

MARKET DIGEST



FRIDAY, NOVEMBER 5, 2010

NOVEMBER 4 DJIA 11,434.84
UP 219.71

Good Morning. This is the Market Digest for Friday, November 5, 2010, with analysis of the financial markets and comments on **American Express Co., Boston Scientific Corp., Northrop Grumman Corp., Qualcomm Inc., Watson Pharmaceuticals Inc., Coca-Cola Enterprises Inc. and Sprint Nextel Corp.**

IN THIS ISSUE:

- Change in Rating: American Express Co.: Upgrading to BUY; 2011 estimate now above consensus (David Ritter)
- Growth Stock: Boston Scientific Corp.: Tough competition and sales weakness; reiterating HOLD (David Toung)
- Growth Stock: Northrop Grumman Corp.: Maintaining HOLD on weaker defense budget outlook (John Staszak)
- Growth Stock: Qualcomm Inc.: Riding mobile broadband momentum (Jim Kelleher)
- Growth Stock: Watson Pharmaceuticals Inc.: Maintaining BUY and raising target on solid 3Q results (Patrick Cheng)
- Value Stock: Coca-Cola Enterprises Inc.: Maintaining HOLD on valuation (Erin Smith)
- Value Stock: Sprint Nextel Corp.: Reiterating HOLD following 3Q results (Joseph Bonner)

RESEARCH ANNOUNCEMENT:

The following research reports are now available on our website. For additional information about any of these reports, please contact your account representative.

- Weekly Staff Report: November 8, 2010
- Viewpoint: October 2010

CONFERENCE CALL ANNOUNCEMENT:

Argus Research will host a conference call for clients at 11 a.m. EDT on Wednesday, November 10, 2010. The call is entitled “Insurance & REITS: Opportunities in the Financial Services Sector.”

Argus’ Director of Research Jim Kelleher, CFA, will host the call, which will be in webinar format. Jim will be joined by Argus President & Senior Financial Services Analyst John Eade.

Please visit https://www2.gotomeeting.com/register/631865266 to register.
Once on the site, follow simple instructions to sign up for the call and receive a call-in number and passcode. If you have any problems registering, please contact us at clientservices@argusresearch.com or by calling (212) 425-7500.

The call, as always, will be interactive with a question-and-answer period. We will be recording the call, and a rebroadcast will be available on the password-protected portion of our website.

Slides related to the presentation will be posted on our website and also will be available via the webcast itself.

MARKET REVIEW:

U.S. stocks rallied on Thursday, driven by the Federal Reserve’s plan to boost the economy with the purchase of $600 billion in Treasury securities. The Dow rose 1.96%, the Nasdaq jumped 1.46%, and the S&P 500 climbed 1.93%. Bond prices also rose, as the yield on the benchmark 10-year Treasury fell to 2.49%. Crude oil rose $1.80 per barrel to settle at $86.49 on the New York Mercantile Exchange. (Bill Selesky, 11/4/10)

SAMPLE

AMERICAN EXPRESS CO. (NYSE: AXP, $43.73) .... BUY

AXP: Upgrading to BUY; 2011 estimate now above consensus

- Amex's loan losses and delinquency have declined more quickly than at peers, and the company has been reinvesting loss-provision expense savings into marketing and other growth initiatives. These investments are bearing fruit.
- Amex already generates about 50% of its revenue from the discount fee charged to merchants, so it's less exposed than pure card lenders to regulatory changes from the CARD Act and FinReg.
- Amex's recent volume growth has exceeded credit card volume growth rates at both Visa and MasterCard, a testament to Amex's higher-end clientele.
- Amex trades at just 11-times the 2011 consensus EPS estimate and at just over 10-times our above-consensus forecast, a discount to its long-term average forward P/E in the mid-teens as well as to the multiples of peers such as Visa (14.0) and MasterCard (15.5).

ANALYSIS

INVESTMENT THESIS

We are raising our rating on American Express Co. (NYSE: AXP) to BUY from HOLD and setting a 12-month target price of $50. We are also raising our EPS estimates for 2010 and 2011. Our 2011 estimate is now about 10% above the current consensus.

Amex has shifted emphasis to its transaction-based revenue model from the lending-centric model that it diversified into over the past decade. Nevertheless, Amex's loan losses and delinquency have declined more quickly than at peers, and the company has been reinvesting loss-provision expense savings into marketing and other growth initiatives. These investments are bearing fruit.

Amex already generates about 50% of its revenue from the discount fee charged to merchants, so it's less exposed than pure card lenders to regulatory changes from the CARD Act and FinReg. While Amex's loan portfolio continues to shrink, the pace of decline has slowed in recent quarters. Although the CARD Act has hurt the net interest yield on the portfolio, we expect the yield to begin to stabilize next year as well.

Amex has a diversified base of consumer and business customers that use charge accounts (which must be paid in full each month) and revolving credit card accounts. Spending per card is now growing at a mid-teens pace and is driving similar growth in spending volume. Amex's recent volume growth has exceeded credit card volume growth rates at both Visa and MasterCard, a testament to Amex's higher-end clientele.

Amex trades at just 11-times the 2011 consensus EPS estimate and at just over 10-times our above-consensus forecast, a discount to its long-term average forward P/E in the mid-teens as well as to the multiples of peers such as Visa (14.0) and MasterCard (15.5). Discover, which like Amex owns a card loan portfolio, trades at a similar forward P/E of about 10.

The other major recent development for American Express concerns the Justice Department's recent antitrust lawsuit against the card networks. Visa and MasterCard both agreed to a settlement but Amex has decided to fight the suit, which may take years to settle. While Amex shares initially sold off on the news, the share price quickly recovered and is now higher than it was before the news broke. We discuss this issue in more detail below.

RECENT DEVELOPMENTS

On October 21 after the closing bell, American Express reported 3Q10 earnings from continuing operations of $0.90 per share, up from $0.44 in 3Q09 and $0.84 in the previous quarter.

Reported revenues were up 17% year-over-year in 3Q10, but this was primarily because of an accounting change that brought loans back onto the balance sheet at January 1, 2010. Adjusted for this change, revenues were up 5% from the year-ago quarter. Card volume increased 14% year-over-year versus 16% growth in the previous quarter. Thus, discount fees, which account for about half of AXP's revenue, were up 13%. However, net interest revenue on a managed basis was down 16% as the managed loan portfolio fell another 14% and the net interest yield declined slightly. Customers are paying down debt, but Amex has also consciously shifted strategy to focus more on transactors like its charge card customers — hence the huge disparity between volume growth and loan balance declines. Total expenses were up 28% year-over-year, but mostly due to increased marketing and rewards spending. Personnel expenses were up just 7%.

SAMPLE

The main story in 3Q, as it has been in other recent quarters, was that credit quality continued to improve. In the loan portfolio, delinquency and charge-off rates were down again both sequentially and year-over-year. As a result, Amex has been releasing loss reserves (which boosts earnings). Provision expense was just 32% of charge-offs in the quarter. Nevertheless, loss rates and bankruptcy filings remain at elevated levels. In the U.S., loss reserves cover 7.7% of loans, down from 9.5% two quarters earlier. To its credit, Amex is reinvesting a large portion of the released reserves back into the business. Marketing spending of $847 million was up 68% from the depressed year-earlier level. Rewards spending was also up 26%, outpacing volume growth.

The other major recent development for American Express concerns the Justice Department's antitrust lawsuit against the card networks. Visa and MasterCard both agreed to a settlement, but Amex has decided to fight the suit.

In essence, the suit would give merchants the ability to steer customers between credit card products. Merchants already have the ability to offer discounts to customers who pay by cash, check, or debit card instead of credit card. Credit cards carry higher merchant discount rates than do debit cards. However, most merchants have not bothered to offer such customer discounts for any number of reasons: they don't want to train their clerks, slow transactions at the register, or alienate customers. If debit card discount rates are lowered significantly (the Fed is studying this issue), then merchants may indeed try to steer customers to debit versus credit. (Recall that Amex does not issue debit cards). Again, however, will merchants risk alienating their customers? Consumers want to use the payment product that best suits their needs irrespective of what's best for the merchant. In addition, debit card issuers are probably going to start eliminating rewards and raising fees on debit cards to make up for lost revenues from reduced interchange and lower overdraft fee revenue.

According to Amex, its average discount rate is about 25 basis points greater than the average Visa and MasterCard rate. The Justice Department asserts that Amex has market power, but the card network's volume puts it a distant third behind Visa and MasterCard, and previous suits have recognized this fact. Visa and MasterCard have settled the case and Amex has elected to fight because it obviously fears that it would lose volume. Ironically, this would make the two dominant players even more dominant.

We see Amex's points but its arguments are a bit inconsistent. On the one hand, merchants have been reluctant to steer customers between payment options in the past and Amex asserts that the relatively tight discount rate range between Visa's highest and lowest rate products (90 basis points, or $0.90 on a $100 purchase) would likely not be enough to cause merchants to steer customers. However, if this is true, why is Amex fearful that merchants will switch from Amex to Visa or MasterCard to save an average of just 25 basis points? We believe the answer may lie in the use of average rates in Amex's examples. The actual rate differentials in some cases are much larger.

SAMPLE

In any event, Amex is correct in its assertion that consumers should be the ones making the choices, not the government or the merchants.

The suit may take years to settle. While Amex shares initially sold off on the news, they quickly recovered and are now trading higher than they were before the news broke.

EARNINGS & GROWTH ANALYSIS

We are raising our 2010 earnings forecast to $3.37 from $3.20, implying a 4Q estimate of $0.90 per share, or flat with 3Q. Amex earned $1.62 per share in 2009. We are raising our 2011 estimate to $4.00 from $3.45, now well above the current consensus of $3.68 per share.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating for American Express is High.

Amex's capital ratios have continued to grow. AXP reported a tangible common equity to risk-weighted assets ratio of 11.5% at September 30, 2010 and a total risk-based capital ratio of 13.9%.

American Express is the only major bank to retain most of its common stock dividend payout. AXP's annual dividend rate of $0.72 per share is 18% of our revised 2011 EPS estimate. The dividend yield is about 1.7%, which is slightly above average for American Express.

MANAGEMENT & RISKS

Amex believes that the CARD Act will have a more significant impact on its business than the FinReg bill. However, the CARD Act will have a bigger impact on card issuers that rely more heavily on interest income and penalty fees from revolving products. Half of Amex's revenue comes from the discount rate charged to merchants. Revised late fee rules under the CARD Act took effect in August, but Amex does not expect these rules to have a material impact. However, it does expect other CARD Act changes to cause the net interest yield on its portfolio to decline back towards 9% from recent levels of greater than 10%. Indeed, the net interest yield was 9.5% in 3Q10 versus 10.2% in 3Q09. The company has been repricing accounts in recent quarters in an effort to mitigate this impact.

As for FinReg, the law applies to debit cards, which Amex does not currently offer. However, merchants will now be allowed to offer discounts for payments made with debit cards instead of credit cards, and since Amex does not offer debit, this may have an impact. On the other hand, debit card issuers will be facing huge revenue pressures as a result of recent regulatory changes. The issuers may therefore seek to assess new debit card fees and such increases may push consumers to other cards, such as Amex's charge cards.

American Express is broadly exposed to global economic conditions, because its revenue growth depends on growth in spending by both consumers and businesses. In fact, discount fees now account for about 50% of the company's revenue. However, in contrast to Visa and MasterCard, American Express has a large card loan portfolio of about $50 billion that has suffered in recent quarters from declining balances, lower revenue yields, and elevated credit losses.

A major long-term risk for AXP is that the discount rate – the rate the company charges merchants for transactions – could continue to decline. If it does, AXP will need to add even more accounts and drive more spending volume to compensate for the lost revenue. At the same time, the discount rate gap between American Express and both Visa and MasterCard has narrowed in recent years, thereby increasing the value proposition for Amex merchants. AXP has also demonstrated to merchants that card member spending is typically much greater on Amex cards than on either Visa or MasterCard.

COMPANY DESCRIPTION

American Express is a leading global provider of payment and travel services to consumers, small businesses and large corporations. The company has a market cap of about $50 billion.

INDUSTRY

We have raised our rating on the Financial Services sector to Market-Weight from Under-Weight. Positive factors for the sector include strong earnings estimates that are being upwardly revised and attractive valuations. But risks remain high given the state of the housing market.

The sector accounts for 15.8% of the S&P 500. Over the past five years, it has ranged from 12% to 22%. We think the sector should account for 14%-17% of diversified portfolios. The sector has not performed well in 2010, trailing the S&P 500 on a year-to-date basis and during 3Q.

Turning to fundamentals, the picture has become more favorable. The projected P/E ratio on 2011 earnings is 11.0 versus the market multiple of 12.5. But the price/sales ratio of 2.9 tops the market average of 0.9, and the PEG ratio of 2.3 is ahead of the market reading of 1.8. As for earnings expectations, the outlook for 2010 is bullish – analysts are now calling for 250% growth from depressed 2009 levels, and for a gain of 18% in 2011. Yields are below average, as many banks, REITS and insurance companies slashed or suspended dividends during the financial crisis.

VALUATION

Amex trades at just 11-times the 2011 consensus EPS estimate and at just over 10-times our above-consensus forecast, a discount to its long-term average forward P/E in the mid-teens as well as to the multiples of peers such as Visa (14.0) and MasterCard (15.5). Discover, which like Amex owns a card loan portfolio, trades at a similar forward P/E of about 10.

Using discounted cash flow analysis with our EPS estimates for this year and next, and our long-term growth rate estimate of 10%, we estimate a fair value for AXP of $50 per share, above current levels. AXP carries a beta of about 2.0, but all large-cap financials have been much more volatile in recent years.

On November 4, BUY-rated AXP closed at $43.73, up $1.66. (David Ritter, 11/4/10)

SAMPLE

BOSTON SCIENTIFIC CORP. (NYSE: BSX, $6.49) .... HOLD

BSX: Tough competition and sales weakness; reiterating HOLD

- Boston Scientific reported better-than-expected 3Q10 results; however, it must still recover from the interruption of implantable defibrillator shipments earlier this year, and overcome declining sales of cardiac rhythm management devices and coronary stents.
- The sale of Boston's neurovascular unit to Stryker, which is expected to close before the end of 2010, will generate about $1.2 billion in net proceeds that will be used mainly to pay down debt.
- BSX shares trade at 14.7-times our 2011 EPS estimate, at the high end of the range for our coverage universe of med-tech stocks.
- Given that the company's two largest business segments – CRM and cardiovascular – are facing declining sales and substantial pricing pressures, we think this valuation is expensive.

ANALYSIS

INVESTMENT THESIS

HOLD-rated Boston Scientific Corp. (NYSE: BSX) delivered better-than-expected 3Q10 results. However, it must still recover from the interruption of implantable defibrillator shipments earlier this year, and overcome declining sales of cardiac rhythm management devices and coronary stents. Like other device makers, it is also facing more pronounced pricing pressures.

RECENT DEVELOPMENTS

The forthcoming sale of the neurovascular business to Stryker bolsters BSX's balance sheet, but what does this mean for its long-term strategy?

We see the company as refocusing on its core businesses of cardiac rhythm management, cardiovascular, endosurgery, and neuromodulation.

The neurovascular unit makes coils used to treat stroke patients. The sale of the unit to Stryker, which is expected to close before the end of 2010, will generate about $1.2 billion in net proceeds that BSX will use mainly to pay down debt. Certainly, a stronger balance sheet will give the company greater flexibility in deciding whether to invest internally or make acquisitions. While the neurovascular business, with 2009 sales of $348 million, is a high-margin unit, it has been losing market share due to increased competition. It will now be up to Stryker to turn the unit around, while BSX redeploys its resources in its core businesses.

In the meantime, BSX's two largest business segments – cardiovascular and cardiac rhythm management (CRM) – continue to show declines due to lower procedural volumes and increasing pricing pressures.

For the third quarter, GAAP net income came to $190 million or $0.12 per share, compared to a net loss of $94 million or $0.06 per share a year earlier. On an adjusted basis, which excludes certain charges for intangible asset impairment, restructuring, and litigation expenses, non-GAAP EPS came to $0.19, flat with the prior year.

Net sales declined 5.4% (or 5.2% currency-neutral) to $1.916 billion. While sales exceeded management's guidance, this was still the third straight quarter of declining sales.

By segment, sales of cardiovascular products fell 7.7% while sales of CRM products dropped 9.5%. Within cardiovascular, sales of coronary stents fell 12.4% due to stiff pricing pressures and increased competition. Within CRM, sales of implantable defibrillators fell 8.8% and pacing sales tumbled 11.7%.

The adjusted gross margin for 3Q was 68.1%, down 150 basis points from last year. The decline was driven by the shipment suspension of ICDs in March and April, a product mix shift in coronary stents, and pricing pressures in the U.S. and Japan. The adjusted operating margin was 21.0%, down 80 basis points from the prior year. Lower spending on SG&A, R&D and royalty expenses helped to mitigate the negative effects of the lower gross margin.

In 2Q10, the company reported GAAP net income of $98 million or $0.06 per share, compared to $158 million or $0.10 per share a year earlier. Sales were $1.928 billion, down 7% on both a reported and currency-neutral basis.

EARNINGS & GROWTH ANALYSIS

BSX has raised its guidance following the 3Q results, and now expects adjusted EPS of $0.63-$0.66, up from a prior view of $0.54-$0.62. Adjusted EPS exclude restructuring costs and amortization expenses. The company also expects revenue of $7.729-$7.804 billion, up from a prior $7.6-$7.9 billion. In addition to tightening the range, the revised guidance raises the midpoint to $7.7665 billion from $7.750 billion.

SAMPLE

Based on these factors, we are raising our 2010 adjusted EPS estimate to $0.37 from $0.28. We are lowering our 2011 estimate to $0.44 from $0.46. This revised estimate incorporates $0.04-$0.06 per share of dilution from the neurovascular sale as well as our forecast for modest top-line growth in 2011. Our adjusted EPS estimates for both 2010 and 2011 include $0.28 per share in amortization charges related to the Guidant acquisition.

FINANCIAL STRENGTH

Our financial strength rating on Boston Scientific is Medium, the midpoint on our five-point scale. While the company has been paying down debt, it has also had to make large payments related to the litigation settlement with J&J and a milestone related to the approval of the XIENCE coronary stent in Japan. In the first six months of 2010, it generated cash flow of $2 million, compared to $680 million in the prior-year period. The debt/equity ratio at the end of 2Q10 (the most recently filed 10-Q) was 48%, compared to 44% at the end of 2Q09. The cash balance at the end of the quarter stood at $811 million, compared to $1.194 billion a year earlier.

RISKS

Boston Scientific faces regulatory and technological risks. To fill its product pipeline, the company needs to develop and launch new products. It also needs to obtain marketing and reimbursement approval from the relevant regulators. Product recalls and product advisory notices are common in the medical device industry, and may stop or slow the marketing of products.

BSX's cardiac rhythm management products face competition from industry leader Medtronic and from St. Jude Medical. Its coronary stents face challenges from rivals Abbott Labs, J&J and Medtronic.

We note that product pricing and customer demand are dependent on the reimbursement policies set by government agencies and managed care companies. Governments in Europe and Japan, in particular, have imposed significant price cuts on medical devices.

COMPANY DESCRIPTION

Headquartered in Natick, Massachusetts, Boston Scientific is a developer, manufacturer and marketer of medical devices used in a range of interventional medical specialties, including interventional cardiology, peripheral interventions, vascular surgery, electrophysiology, neurovascular intervention, oncology, endoscopy, urology, gynecology and neuromodulation.

VALUATION

BSX shares trade at 14.7-times our 2011 EPS estimate, at the high end of the range for our coverage universe of med-tech stocks. Given that the company's two largest business segments – CRM and cardiovascular – are facing declining sales and substantial pricing pressures, we think this valuation is expensive. At the same time, we believe that these negatives will be partly offset by the launch of the company's Promus coronary stents in the U.S. and Japan, which we expect in 2012. For now, our rating remains HOLD.

On November 4, HOLD-rated BSX closed at $6.49, up $0.03. (David H. Toung, 11/4/10).

SAMPLE

NORTHROP GRUMMAN CORP. (NYSE: NOC, $65.27) .... HOLD

NOC: Maintaining HOLD on weaker defense budget outlook

- We expect Northrop to face pressure from slower U.S. defense spending over the next several years.
- In particular, the 2011 defense budget calls for lower production in several shipbuilding programs, including the construction of U.S. Navy aircraft carriers, for which Northrop is the primary contractor.
- We are reiterating our 2010 EPS estimate of $6.72 and our 2011 estimate of $6.80.
- We believe that NOC shares adequately reflect prospects for less rapid near-term growth.

ANALYSIS

INVESTMENT THESIS

We are maintaining our HOLD rating on Northrop Grumman Corp. (NYSE: NOC), as we believe that budget constraints will result in slower U.S. defense spending growth over the next several years. In particular, we note that the 2011 defense budget calls for lower production in several shipbuilding programs, including the construction of U.S. Navy aircraft carriers, for which Northrop is the primary contractor. We recommend that investors purchase such BUY-rated industrial names as Emerson (EMR), and Parker Hannifin (PH).

Over the long term, we expect Northrop Grumman to benefit from extensive stock repurchases (more than $1.0 billion over the past five years), as well as from its participation in the F-35 joint strike fighter program. We also expect solid results in defense electronics and cyber security as well as growth in the Shipbuilding and Aerospace segments, driven by the Virginia Class submarine and manned and unmanned aircraft programs.

RECENT DEVELOPMENTS

Northrop Grumman reported adjusted 3Q10 EPS of $1.64, above our estimate of $1.50 and the consensus forecast of $1.46. Adjusted earnings in the year-ago quarter were $1.45 per share. Higher margins and sales, a lower share count and lower-than-anticipated interest expense drove the earnings beat. Consolidated sales rose 4.4% year-over-year to $8.7 billion, above our forecast of $8.5 billion. Revenues increased 1.2% in Shipbuilding, and 25.9% in Technical Services. Information & Services reported a 0.2% decline in revenue, while Aerospace and Electronic Systems revenues were up 7.1% and 1.9%, respectively. NOC's third-quarter operating margin was 9.8%, up 80 basis points from the prior-year period and slightly above our estimate. Electronic Systems and Aerospace reported strong operating margins of 13.9% and 11.2%, respectively. Net interest expense decreased more than 10% to $68 million, while the number of shares outstanding fell 7.2% to 298 million. Third-quarter free cash flow was $817 million.

In May, management raised the quarterly dividend 9.3% to $0.47, or $1.88 annually. We expect NOC to continue to return cash to shareholders through share repurchases and dividend increases.

In early March, Northrop Grumman announced that it would not bid on a $35 billion in-flight refueling tanker for the Department of Defense. NOC believes that Boeing's smaller tanker based on the 767 is better suited to the DoD's needs, and did not expect the tanker program to be profitable.

EARNINGS & GROWTH ANALYSIS

Following a 4.5% gain in 2009 (restated to reflect the sale of the TASC advisory business), we now forecast a 3.2% revenue increase in 2010, down from our prior forecast of 4.0% growth. We project 7% revenue growth at Technical Services and 4% growth at Aerospace Systems, below our previous forecasts of 9% and 5%, respectively. We also expect more moderate revenue growth of 2.0% in Electronic Systems and 2.6% in Shipbuilding, versus our previous forecast for 3% growth in both of these segments. We still expect NOC to benefit from new contracts at Electronic Systems, solid demand for manned and unmanned aircraft at Aerospace, and increased production of submarines in the Shipbuilding segment.

We expect the operating margin to hold steady at 8.7% in 2010, as reduced pension expense is offset by lower profitability at Electronic Systems (still the company's highest margin unit). To reflect less robust revenue growth driven by defense spending pressures, and challenges at the Gulf Coast shipyards, we are maintaining our 2010 EPS estimate of $6.72. We lowered this estimate from $6.78 in August. For 2011, based on prospects for further defense budget pressures and higher pension expense resulting from reduced investment returns, we project EPS of $6.80, up just 1% from our 2010 estimate. Our five-year earnings growth rate forecast remains 10%.

FINANCIAL STRENGTH & DIVIDEND

We are maintaining our financial strength ranking for Northrop at Medium-High, the second-highest rank on our five-point scale. Cash and cash equivalents totaled nearly $2.5 billion at the end of the third quarter, down from $3.3 billion at the end of 2009. But total debt of $4.2 billion was essentially unchanged from the end of 2009. Long-term debt/total capital dropped from 24.8% at the end of 3Q09 to 20.7% at the end of 3Q10. NOC generated third-quarter free cash flow of $817 million.

Standard & Poor's rates NOC's corporate debt as BBB+, while Moody's rating is Baa1. Both agencies have a stable outlook on NOC.

In May, the company raised its quarterly dividend from $0.43 to $0.47 per share, or $1.88 annually, for a yield of about 3.0%. We forecast payouts of $1.84 in 2010 and $2.00 in 2011.

MANAGEMENT & RISKS

Northrop Grumman is a diversified defense contractor. As a result, the risk to any one of the company's platforms is mitigated by the breadth of its operations. For example, when cutbacks were made in the Virginia-class submarine program, Northrop's other business units remained strong. Nevertheless, cuts in multiple programs would affect the company's performance and its efforts to improve margins.

VALUATION

NOC shares are trading at 9.7-times our 2010 EPS estimate and at 9.6-times our 2011 forecast, below the five-year historical average of 14.1. Comparable aerospace/defense companies have historically traded at EV/EBITDA multiples just below 8. Given our expectations for improved margins, offset by limited growth in the defense budget, we believe that an average EV/EBITDA multiple is now warranted. Multiplying our EBITDA estimate by 8 generates a fair value near $65, in line with current prices. As such, our rating remains HOLD. If defense spending grows more rapidly than we project or the company is able to quickly resolve problems at its Gulf shipyards, we would consider an upgrade.

On November 4, HOLD-rated NOC closed at $65.27, up $0.99. (John Staszak, CFA, 11/4/10)

SAMPLE

QUALCOMM INC. (NGS: QCOM, $48.34) .... BUY

QCOM: Riding mobile broadband momentum

- Qualcomm posted better-than-anticipated fiscal 4Q10 results and forecast a strong start to fiscal 2011.
- The fourth quarter featured record levels of mobile station modem (MSM) chipset shipments, leading to record EPS.
- The fiscal 2011 outlook suggests accelerating momentum, as Qualcomm's various 3G smartphone and tablet initiatives dovetail with early rollouts of 4G networks.
- Though not confirmed, Qualcomm is widely expected to be the exclusive chipset supplier for 3G CDMA-based iPhones on the Verizon Wireless network.

ANALYSIS

INVESTMENT THESIS

BUY-rated Qualcomm Inc. (NGS: QCOM) posted better-than-anticipated fiscal 4Q10 results and forecast a strong start to fiscal 2011. The fourth quarter featured record levels of mobile station modem (MSM) chipset shipments, leading to record EPS, and the fiscal 2011 outlook suggests accelerating momentum, as Qualcomm's various 3G smartphone and tablet initiatives dovetail with early rollouts of 4G networks. Qualcomm is the dominant chipset supplier to smartphones using the Android operating system, now the leading OS for smartphones. Though not confirmed, it is also widely expected to be the exclusive chipset supplier for 3G CDMA-based iPhones on the Verizon Wireless network; we also anticipate that Qualcomm will become the exclusive supplier to all iPhones from iPhone 5 (for 4G LTE) and beyond. The royalty and licensing business will only grow larger as more and more 2G phones are retired and replaced by 3G and 4G smartphones. We are reiterating our BUY rating on QCOM to a 12-month target price of $56.

SAMPLE

RECENT DEVELOPMENTS

Year-to-date, QCOM shares are up 5%, lagging the strong 29% simple-average gain for the peer group of six Argus-covered communications semiconductor stocks (14% on a cap-weighted basis). QCOM has rapidly been gaining ground on its peer group, moving up from $31 at the beginning of July to the $48-$49 level at present. The stock has lagged in 2010 as in 2009, partly because it preserved its value better than the peer group in 2008, falling just 9% compared with a 70% decline for its communications semiconductor brethren.

In our QCOM note of 9/20/10, we forecast a "modest upside surprise from Qualcomm in fiscal 4Q10," but there was nothing modest about the company's upside beat. Fiscal 4Q10 results for Qualcomm were so solid that QCOM shares are accelerating and closing the year-to-date performance lag with the peer group. Revenue of $2.95 billion rose 10% year-over-year and 9% sequentially, and was at the top of the company's guidance range. Non-GAAP EPS of $0.68 and GAAP EPS of $0.53 per diluted share were at record levels. Qualcomm generated $1.1 billion in cash flow from operations in the quarter and $4.1 billion for all of fiscal 2010, and finished fiscal 2010 with $18.4 billion in cash and $1 billion in debt (its first debt in over a decade). MSM shipments were a record 111 million chipsets.

For the full fiscal year, revenue of $11 billion was up 6% year-over-year. But with margins improving despite declining 3G device ASPs, adjusted operating income of $4.3 billion rose 37% year-over-year. The growing cash horde at Qualcomm continues to throw off ever-more interest income; that contributed to 88% year-over-year growth in pro forma EPS, to $2.46. Qualcomm shipped 399 million MSM chipsets for the full year. For calendar 2010, and based on forecast MSM shipments of 115-119 million in fiscal 1Q11 (calendar 4Q10), Qualcomm will have shipped 424 million chipsets in calendar 2010 – up 22.5% from 346 million in calendar 2009.

At the same time, the value of the 3G device market rose just 7.1% to $105.7 billion in calendar 2010, compared with $98.5 billion in calendar 2009. The much lower rate of growth (7%) in the value of 3G handsets partly reflects lower average ASPs for the year; Qualcomm expects calendar 2010 ASPs to be around $186 per unit, which would be down 4% year-over-year. But 7% device value growth and 4% lower ASPs do not fully close the gap with 22.5% growth in MSM chipsets. The implication is that Qualcomm is on track to take substantial handset semiconductor market share in calendar 2010.

Not everything worked out for Qualcomm in fiscal 2010. Bowing to reality, Qualcomm announced that it had initiated a restructuring plan under which it intends to exit its existing FLO TV services business. Despite all the video whizzing around the web, consumers have been loath to pay additional sums to watch programming on their handsets that they get free or already pay for on large-screen TVs. Qualcomm will incur charges of $125 million to $175 million, primarily related to existing contractual charges. The company is evaluating strategic options, which include operating FLO TV under a new wholesale service; selling the business to a third party or operating it as a JV; or discontinuing the service altogether and selling its valuable spectrum licenses. This last option looks best, as it would free up spectrum and end the losses in QSI associated with this business.

In addition, the Qualcomm Wireless & Internet business (QWI) continues to limp along, barely above break-even. But the two main businesses, Qualcomm CDMA Technology (QC) and Qualcomm Technology Licensing (QTL), are accelerating to new growth rates, based on growing acceptance of Qualcomm's silicon solutions and overall growth in 3G handsets and smartphones, as well as handset makers readying devices for rapidly approaching 4G networks.

While the focus has been on mobile phone silicon, QCT is executing in the netbook and tablet space as well. The Snapdragon platform, which combines baseband and an ARM-based application processor, is in an estimated 75% or more of all Android-based smartphones. This includes the complete Motorola smartphone line-up, which went from negligible sales a year ago to 3.8 million units in 3Q10. Other WCDMA and snapdragon chipsets are being featured in Windows 7-based phones.

The QTL business now counts 185 licensees around the world, including 14 new Chinese-based licensees added in fiscal 2010. Despite the addition of high-volume licensees such as Nokia, based on our estimate of CDMA device value in 2010 and QTL's full-year revenue of $3.6 billion, we estimate that average per-handset royalty is 3.4% — not far from the prevailing 3.8% rate in recent years.

The average royalty rate came down slightly in the quarter to the 3.3%-3.25% range, and that may partly reflect the "royalty caps" that are in place for certain tablet devices. The 3%-4% royalty rates that Qualcomm has historically commanded did not envision the tablet market, where devices cost from $500 to $800 and where computing rather than communications is the primary goal (or perhaps they are inextricably entwined). Going forward, tablet royalty caps will drive down QTL revenue as a percentage of total device revenue.

A bigger factor in the total device market may be the likelihood of more and more entry-level smartphones coming to market, along with tiered-pricing data plans that are set to displace higher-cost "all-you-can-eat" data plans. Qualcomm saw CDMA device ASPs tick higher in 2H10 as smartphone growth in mature economies outpaced 3G handset growth in developed economies. That trend should continue in 1H11, but lower-priced smartphones will prevail in 2H11, according to the company. This could depress ASPs slightly, but will ultimately be a volume driver. This is particularly true in China, where CDMA penetration is in the low teens, and in India, which just completed its spectrum auctions and anticipates 3G device proliferation beginning in 2011.

On that basis, QTL is well positioned to grow further, given company forecasts for 20% global unit volume growth to 765 million CDMA handsets in calendar 2011. Based on our calendar 2011 MSM chipset forecast of 541 million units, which implies 23% full-year growth, we expect QCT to take additional market share. And to date, our estimate does not fully reflect the high likelihood that 2011 will be the year in which Apple turns to Qualcomm for its silicon needs.

Apple blogs and insider sites daily share new rumors on the topic, including Verizon hiring extra workers to handle the anticipated order flow, or Foxconn or other ODM companies putting iPhone-ready manufacturing machinery into place. We see a strong likelihood that Qualcomm will displace Infineon as the iPhone baseband supplier, for a variety of reasons. First, to support a CDMA iPhone on Verizon Wireless' network, Apple must turn to Qualcomm as it is the only viable CDMA 1x EV-DO chipset supplier. Second, Apple will find it easier and more economical to use a single baseband supplier for all future iterations of the iPhone – and Qualcomm stands ready as one of the only chip suppliers now sampling 4G chipsets. Finally, Infineon is set to become part of Intel, and Apple may not want to support that giant company which – as the operator of the MeeGo op system – is a direct competitor to the Apple iOS.

Altogether, Qualcomm in 4Q10 sustained the positive momentum visible in the 3Q10 report, and the outlook only improves from here.

EARNINGS & GROWTH ANALYSIS

For fiscal 4Q10 (ended September 30, 2010), Qualcomm reported revenue of $2.95 billion, up 10% year-over-year and 9% on a sequential basis. Equipment and Services revenue of $1.95 billion in 4Q10 was up 10% year-over-year and sequentially. Licensing & royalty revenue of $1.0 billion was up 9% year-over-year and 7% sequentially. We remind investors that Qualcomm uses a three-month lag for its estimation of royalty & licensing revenue, and so licensing & royalty income in fiscal 4Q10 (ended September) reflected the June 2010 calendar quarter.

GAAP gross margin was sequentially consistent at 66.5% in 4Q10 compared with 66.6% in 3Q10. GAAP gross margin was 69.4% a year earlier. Pro forma operating margin, however, improved sequentially to 38.2% in 4Q10 from 36.8% in 3Q10 and was up meaningfully from 31.2% a year earlier.

SAMPLE

On a GAAP basis, Qualcomm reported a profit of $0.53 per diluted share in 4Q10, compared with $0.47 per diluted share in 3Q10; in the year-earlier quarter, GAAP profit was $0.48 per share. On a pro forma basis, Qualcomm had profits of $0.68 per diluted share in 4Q10, compared with $0.57 per diluted share in 3Q10 and year-earlier pro forma profits of $0.48 per diluted share.

For all of fiscal 2010, Qualcomm had sales of $11.3 billion, up 6% from $10.7 billion for fiscal 2009. Pro forma EPS totaled $2.46 for fiscal 2010, compared with $1.76 for fiscal 2009.

By segment, Qualcomm CDMA Technologies (QCT) reported revenue of $1.86 billion in 4Q10, up 9% year-over-year and 10% sequentially. QCT segment income was $519 million in 3Q10, up from $404 million in 3Q10; the profit gain reflected a richer mix of high-end chipsets sold into mature economies for smartphones. In the year-earlier period, QCT earned $508 million.

QCT shipped a record 111 million MSM chipsets in 4Q10, up from 103 million MSM chipsets in 3Q10 and 91 million in 2Q10; in the year-earlier quarter, chipset shipments were 91 million. Chipsets bottomed in the 66 million range in both 1Q09 and 2Q09, as a result of the global recession and inventory drawdowns at distribution, and then idled in the 90 million range for several quarters. Looking to the current 1Q11, QCT anticipates shipments of 115-119 million MSM chipsets.

Qualcomm Technology Licensing (QTL) reported revenue of $921 million for 4Q10, up 9% from $847 million in 3Q10 and 10% from $837 million a year earlier. QTL reports on a lagged basis, and 4Q10 results reflect royalty payments for the April-June period (calendar 2Q10, but Qualcomm's 3Q10). We look for royalty revenue averaging approximately $950 million to as high as $1.0 billion per quarter in FY11, compared to a fiscal 2010 average of $915 million per quarter. Operating income for QTL was $754 million in 4Q10, up from $673 million in 3Q10 and $693 million in 4Q09.

Management projects 1Q11 revenue of $3.0-$3.4 billion, which on a year-over-year basis indicates an increase of 14%-26%. Pro forma EPS for the quarter is forecast at $0.70-$0.4, which would be up 13%-19% year-over-year.

On a preliminary basis, for all of fiscal 2011, management forecasts revenue of $12.4-$13.0 billion, up 13%-18% from fiscal 2010; and pro forma EPS of $2.63-$2.77, up 7%-13% from fiscal 2009.

For FY11, our pro forma earnings forecast is $2.97 per diluted share, up from $2.66. For fiscal 2012, we are implementing a forecast of $3.34 per diluted share. On a GAAP basis, our estimates are $2.34 for FY11 and $2.64 for FY12. Our long-term EPS growth rate forecast remains 15%.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating for Qualcomm is High, the top of our five-point scale. The company, long debt-free, has added approximately $1 billion in debt, possibly to establish lending arrangements should it seek to pursue a major acquisition. At this time, we do not believe Qualcomm has any such plans.

SAMPLE

Cash & investments were $18.4 billion at the end of 4Q10, up nearly $3 billion from $15.7 billion at the end of 3Q10. Cash was $18.2 billion at the end of 2Q10. Qualcomm repurchased $1.3 billion in common stock in fiscal 3Q10; the company also spent over $1 billion to purchase wireless spectrum in India. Cash & investments totaled $17.7 billion at the end of FY09, up from $15.7 billion at the end of 3Q09. Cash & investments were $11.25 billion at the end of FY08, $11.8 billion at the end of FY07, and $9.95 billion at the close of FY06.

Cash flow from operations totaled $4.1 billion in FY10. For all of FY09, and including $2.5 billion in a lump-sum payment from Nokia, cash flows from operations were $7.2 billion ($4.8 billion excluding the Nokia payment). Cash flow from operations was $3.56 billion for all of FY08, $4.25 billion in FY07, $3.25 billion in FY06, and $2.7 billion in FY05. Pro forma free cash flow was $3.52 billion in FY08, compared to $3.53 billion in FY07 and $3.18 billion in FY06.

Qualcomm repurchased $3.02 billion in stock in FY10 and paid over $870 million in dividends. Returns to investors in FY09, including share repurchases and common dividends, totaled $1.4 billion; the company repurchased just $280 million in stock in FY09, after spending $1.5 billion-plus in the prior three years. Returns to investors in FY08, including share repurchases and common dividends, totaled $2.65 billion. In FY07, returns to investors exceeded $2.34 billion, compared to $2.2 billion in FY06 and $1.5 billion in FY05. Qualcomm has repurchased over $14 billion of its stock since FY03. Despite an aggressive share repurchase program and recent asset impairments, Qualcomm's strong cash flows are keeping its cash balance stable to growing.

In March 2009, when hundreds of companies cut their dividends, Qualcomm announced an increase in its quarterly dividend, to $0.17 per common share from $0.16. Qualcomm now pays a quarterly dividend of $0.19 per common share. We estimate annual dividend payouts of $0.76 for both FY11 and FY12.

MANAGEMENT & RISKS

Paul Jacobs, who has served as Qualcomm CEO since July 2005, became chairman of the board in March 2009; founder Dr. Irwin Jacobs ceded the chairmanship but remains on the board. Bill Keitel is the long-serving CFO. Former COO Dr. Sanjay Jha left to run Motorola's Mobile Devices division during fiscal 4Q08, setting off several executive changes. Len Lauer is COO; Steve Mollenkopf, the head of the semiconductor business, has been promoted to executive vice president and group president; and Derek Aberle runs the QTL royalty & licensing arm. Steve Altman remains president.

Qualcomm's semiconductor business is at risk from established players as well as low-cost entrants in Asia and elsewhere. In general, we believe that the company-specific risks are offset by Qualcomm's proven track record, its well-established relationships with equipment vendors and carriers, and its ability to continually advance code division wireless technology to the next level and next market opportunity.

COMPANY DESCRIPTION

Qualcomm is a designer and manufacturer of semiconductors for wireless phones and other equipment for advanced commercial wireless applications. The company is the chief architect and proponent of the third-generation CDMA wireless standard. Qualcomm holds an extensive intellectual-property portfolio for spread-spectrum technologies, including CDMA and WCDMA/UMTS. The company produces semiconductors for mobile phones as well as integrated processors and basebands for mobile PCs. In addition, Qualcomm produces wireless communications and tracking systems for commercial applications. The company also promotes BREW technology, which permits carriers to differentiate their services with proprietary software applications.

INDUSTRY

Argus currently recommends a Market-Weight position in the Technology sector. For the long term, we expect the technology sector to increase its weighting within the S&P 500 from the current 19% level to near 25%, based on positive company and sector fundamentals. For individual companies, these include high cash levels, low debt, and broad international business exposure. We expect the entire sector to benefit from the transformative effects generated by new developments in technology.

Positives in the picture for information processing & computing companies include the PC and enterprise IT "refresh" cycle that is being driven by the Microsoft Windows 7 launch and Intel's Nehalem family of PC (Core i7) and server (Xeon) processors. Server and storage providers stand to benefit from the battle among computing and communications companies for dominance in the enterprise data center, where protocols such as FCoE are facilitating SAN-LAN convergence — and prompting enormous market-share disruption and M&A activity.

Communications infrastructure players stand to gain from the explosion in network traffic related to the rise of social networking sites, high-bandwidth video on the network, and mobile data. No single trend may be as transformative as the acceleration in mobile broadband, driven by netbooks and smartphones.

VALUATION

QCOM shares currently trade at 16.3-times our FY11 pro forma EPS forecast and at 14.5-times our FY12 projection, compared to an average P/E of 21.2 for FY06-FY10. The shares, which have historically commanded a 26% premium to the market P/E, now trade at an average premium of 12% for FY11 and FY12. Discounted free cash flow modeling signals value near $70, while historical comparables valuation renders a value of $62 per share. Our fair value calculations are substantially above early 2009 levels, and remain well above current prices.

We think that Qualcomm's competitive advantages and financial strength will contribute to relative outperformance. Appreciation to our 12-month target price of $56, along with the current dividend yield of about 1.5%, implies a risk-adjusted return exceeding 15%, better than our benchmark return forecast. On that basis, we are reiterating our BUY rating on QCOM.

On November 4, BUY-rated QCOM closed at $48.34, up $2.65. (Jim Kelleher, CFA, 11/4/10)

SAMPLE

WATSON PHARMACEUTICALS INC. (NYSE: WPI, $50.36) .... BUY

WPI: Maintaining BUY and raising target on solid 3Q results

- Watson reported adjusted cash EPS of $0.85, up 9% year-over-year and a penny above the consensus estimate.
- Total revenues were $882.4 million, up 33% year-over-year and above the consensus estimate of $877 million. Revenue growth benefited from the inclusion of the Arrow Group, which WPI acquired late last year.
- The company tightened its 2010 adjusted EPS guidance range to $3.37-$3.45 from $3.30-$3.45.
- We are raising our 2010 adjusted EPS estimate to $3.41 from $3.40 to reflect the 3Q results. We are also raising our 2011 estimate to $3.92 from $3.86.

ANALYSIS

INVESTMENT THESIS

We are maintaining our BUY rating on Watson Pharmaceuticals Inc. (NYSE: WPI) and raising our target price to $56 from $51. We think that generic drug companies are well positioned to benefit from the public's increased focus on cost-effective care. Watson is a leader in the generic drug industry, and has its own branded products as well. Overall, the company appears on track to deliver low double-digit organic growth in the near term, and valuations are historically attractive.

RECENT DEVELOPMENTS

Watson reported solid 3Q10 financial results. On an adjusted cash basis, EPS rose to $0.85, up 9% year-over-year and $0.01 above the consensus estimate. Third-quarter net revenues were $882.4 million, up 33% year-over-year and above the consensus estimate of $877 million. The revenue growth was primarily due to strong sales of extended-release products and oral contraceptives, as well as the addition of sales from the Arrow Group, which Watson acquired in December 2009. On a GAAP basis, the company posted EPS of $0.21, down from $0.55 in the prior-year period. The year-over-year decline was primarily due to an $89.9 million legal charge recorded in 3Q10.

For the third quarter, the Global Generics segment recorded revenues of $577.6 million, up 45% year-over-year. International sales from the Arrow Group acquisition accounted for 26 percentage points of the growth. The remainder of the increase reflected continued growth in extended-release products and oral contraceptives.

The Global Brands segment had revenues of $99.7 million in 3Q10, a decrease of 11.5%. The decrease was primarily due to the loss of iron deficiency treatment Ferrlecit in December 2009, partially offset by increased sales of Rapaflo, Gelnique, Androderm and Crinone.

The Distribution segment reported 3Q10 revenues of $205.1 million, up 35% year-over-year. Distribution revenues benefited from third-party sales of generic antidepressant Effexor XR, launched in 3Q10, as well as new products launched in late 2009 and the first half of 2010. Distribution revenues represent sales of third-party products and exclude sales of Watson's branded and generic products.

In October, Watson entered into an agreement with Moksha8 to market certain Watson products in Brazil and Mexico.

In November, Watson signed an exclusive agreement with Johnson & Johnson to distribute a generic version of JNJ's Concerta, an ADHD medication, which had U.S. sales of $668 million through the first nine months of 2010. Under the terms of the agreement, which lasts until the end of 2014, Watson will market and distribute an authorized generic of Concerta, which JNJ will manufacture. Watson plans to launch the authorized generic in May 2011.

EARNINGS & GROWTH ANALYSIS

Along with the 3Q10 financial results, management updated its financial guidance for 2010. Watson reaffirmed its revenue guidance of $3.5 billion and tightened its 2010 EPS guidance range to $3.37-$3.45 from $3.30-$3.45.

We expect 2010 revenue to increase 25% to $3.5 billion, primarily reflecting the December 2009 acquisition of Arrow Group. With 36 generic drug approvals filed in 2009, contributions from new products should drive generic volume higher. Significant new products include Toprol XL, Cardizem LA, Concerta, Lovenox and Lotrel. We believe that distribution revenue is likely to grow, but branded product revenue is likely to decline modestly due to the absence of Ferrlecit.

We are raising our 2010 adjusted EPS estimate to $3.41 from $3.40 to reflect the 3Q results. We are also raising our 2011 estimate to $3.92 from $3.86.

Over the long term, we think the biggest opportunities for growth for Watson are to expand in emerging markets and to develop follow-on biological drugs. The Arrow acquisition and the Moksha8 agreement should help Watson with geographic expansion. Through the Arrow acquisition, Watson also acquired Eden Biopharm Group, which provides development and manufacturing services for early-stage biotech companies. Over time, Eden should help Watson to develop biologic drugs. Our long-term growth rate forecast for Watson is now 12%, up from 10%.

FINANCIAL STRENGTH

Our financial strength rating for Watson is Medium, the midpoint on our five-point scale. The $1.75 billion Arrow acquisition was completed in December 2009. To fund the $1.05 billion cash portion of the deal, the company used cash on hand and also tapped $275 million under its revolving credit facility. It also issued $200 million in zero-coupon, nonconvertible preferred stock; these preferred shares are mandatorily redeemable in 2012 and in the meantime will be treated as debt. This brought total debt up to $1.5 billion at the end of 2009 from $1.0 billion at the close of 3Q09, while the cash balance dropped to $215 million from $826 million. As of the end of 3Q10, the cash balance was $266 million and total debt was $1.2 billion. The total debt/capital ratio at the end of 3Q10 stood at 27.1%, down from 32.5% at the end of 2009.

Watson does not pay a dividend at this time, and we do not expect it to initiate one in the near term.

RISKS

The expiration of the distribution agreement with Sanofi-Aventis for Ferrlecit is a risk for Watson's organic top-line growth. The loss of one of its top sellers will be only partially mitigated if partner GeneraMedix's generic version gains approval.

The U.S. Federal Trade Commission and the State of California have challenged as unlawful Watson and Solvay's 2006 patent settlement regarding AndroGel, in which Watson agreed not to market its generic equivalent product until the earlier of August 31, 2015 (five years prior to the expiration of the AndroGel patent) or the date on which another generic product enters

SAMPLE

the U.S. market. Additionally, Watson agreed to forfeit its 180-day marketing exclusivity on the product awarded under the Hatch-Waxman Act. The companies plan to defend their settlement, but the matter is not likely to be resolved in the near term and the outcome is uncertain.

Another risk is that product flow for generics is often dependent on patent litigation outcomes, which are uncertain and can cause volatility in top-line growth. Many of Watson's filed ANDAs are Paragraph IV patent challenges that are subject to litigation. Watson generally does not disclose its ANDAs – as is typical in the generics industry – until a filing becomes public, usually through litigation brought by the brand manufacturer to defend its patent or through FDA action. While a "win" for Watson on any of the pending Paragraph IV challenges would be positive, this also adds uncertainty to sales and earnings forecasts. In addition, the Paragraph IV patent-challenge process often involves protracted litigation that is costly to all parties.

Finally, there is the risk that the Arrow acquisition will fail to deliver the synergies or sales growth that management anticipates and that it will dilute earnings.

COMPANY DESCRIPTION

Watson Pharmaceuticals, based in Corona, California, is a specialty pharmaceuticals company engaged in the development, manufacture, sale and distribution of both branded and generic drugs. As of the end of 2009, it marketed 170 generic product families and 30 brand product families. The company generated sales of $2.8 billion in 2009 from its Generic (60%), Branded (16%) and Distribution (24%) segments.

VALUATION

We think that WPI shares are attractively valued at current prices near $50. The shares are trading at 12.8-times our 2011 EPS estimate, below the five-year historical average of 19 (range: 11.5-28.4). Our discounted cash flow model, which projects annual growth of about 12% for the next five years and a gradual decline thereafter, produces a theoretical value of $56, which is our revised target price.

On November 4, BUY-rated WPI closed at $50.36, up $1.75. (Patrick Cheng, 11/4/10)

SAMPLE

COCA-COLA ENTERPRISES INC. (NYSE: CCE, $24.40) .... HOLD

CCE: Maintaining HOLD on valuation

- Coca-Cola Enterprises reported solid 3Q10 results, benefiting from volume growth in both carbonated and noncarbonated beverages in Europe.
- CCE expects 2010 pro forma comparable EPS of $1.74-$1.78, pro forma revenue of $7.4 billion, and operating income of just over $900 million.
- We are adjusting our 2010 EPS estimate to reflect management's updated guidance. Our EPS estimates are now $1.76 for 2010 and $2.00 for 2011.
- We believe that CCE shares will move in line with the S&P over the next 12 months, and are therefore maintaining our HOLD rating.

ANALYSIS

INVESTMENT THESIS

HOLD-rated Coca-Cola Enterprises Inc. (NYSE: CCE) reported solid 3Q10 results, benefiting from volume growth in both carbonated and noncarbonated beverages in Europe. The volume growth was in line with second-quarter results and reflected distribution gains in the energy drink category, the addition of new products in the still category (i.e., noncarbonated beverages), and the continued growth of trademark Coca-Cola and Coke Zero. Although we believe that CCE shares could move to the high $20s over the next year, such a gain is largely in line with our expectations for the broad market. As such, we are maintaining our HOLD rating.

RECENT DEVELOPMENTS

Coca-Cola Enterprises reported strong 3Q10 results in Europe, with net revenue up 4.5% and a 5% increase in volume, reflecting growth in both the sparkling (carbonated) and still (noncarbonated) categories. Pricing per case rose 1% and cost of goods per case was flat. These results excluded the company's operations in Norway and Sweden, which were recently acquired from Coca-Cola.

Carbonated volumes rose 3.5%, with 3% growth from trademark Coca-Cola. Noncarbonated volumes rose more than 15%, but most of the gain was due to the addition of new products Capri Sun and Ocean Spray. Energy drink volume rose more than 20%, benefiting from additional distribution and easier year-over-year comparisons.

CCE's 3Q10 EPS, including the Norwegian and Swedish operations, came to $0.58, down from $0.59 a year earlier.

EARNINGS & GROWTH ANALYSIS

CCE's third-quarter European volume growth of 5.5% was in line with second-quarter levels. Volume rose just 3.5% in Great Britain, though this was an improvement from 2Q10. In Continental Europe, volume rose 6%, benefiting from more than 20% growth in noncarbonated beverages and Coke Zero. Management noted that the company has been gaining share in Europe, despite the relative weakness in Great Britain.

CEO John Brock confirmed that CCE has been discussing new initiatives with Coca-Cola Co. as it works to expand distribution and build up its business in Western Europe. Going forward, CCE will focus on enhancing execution and on better matching product offerings and displays to local preferences in individual markets. CCE would also eventually like to acquire Coca-Cola's existing German bottling operations. Expansion outside of Western Europe is a lower priority.

CCE expects 2010 pro forma comparable EPS of $1.74-$1.78, pro forma revenue of $7.4 billion, and operating income of just over $900 million. The EPS guidance includes results from Norway and Sweden but excludes one-time items. Management expects currency effects to reduce EPS by $0.09 per share in 2010. It looks for currency-neutral sales in Europe to grow at a mid-single-digit rate and for operating profit to grow at a high single- to low double-digit pace. The guidance assumes 4Q10 EPS of $0.27-$0.31.

Over the long term, the company expects revenue to increase 4%-6%, operating income to rise 6%-8% and EPS to increase at a high single-digit pace. Management also noted that 2011 results would likely exceed its long-term growth targets due to expected share repurchase activity.

We are adjusting our 2010 EPS estimate to reflect management's updated guidance. Our revised EPS estimates are $1.76 for 2010 and $2.00 for 2011.

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating for CCE remains Medium, the midpoint on our five-point scale. CCE ended 3Q10 with $476 million in cash on hand, up from $404 million at the end of 2009. Total debt was $2.34 billion at the end of the quarter, compared to $2.81 billion at the end of 2009. The total debt/capital ratio declined to 41.7% from 46.9% at the end of 2009. The debt level is slightly below CCE's estimate of $2.4 billion gross debt, and cash is slightly above its estimate of $400 million.

CCE plans to use future cash flow to pay down debt and fund share repurchases, and expects to repurchase approximately $1 billion of its stock over the next 18 months. CCE continues to target a long-term net debt to EBITDA ratio of 2.5-3.0 following the Coca-Cola transaction.

The CCE board recently authorized a quarterly dividend of $0.12 per share, or $0.48 annually, above the previous annualized rate of $0.36. CCE plans to raise its annualized dividend to $0.50 per share in 2011. Our dividend estimates are now $0.39 for 2010 and $0.50 for 2011.

SAMPLE

RISKS

Major risks facing CCE include higher raw material costs, increased competition, the possibility of sales cannibalization from new products, and industry weakness in Europe. Fluctuations in exchange rates are another risk for the new CCE, which will generate all of its sales outside the U.S.

Cost inflation moderated in 2009 and has fallen at a low single-digit rate in 2010. In 3Q10, the cost of goods sold per case was flat in Europe. However, the company expects renewed single-digit cost inflation in 2011, in line with historical trends. CCE has hedged nearly all of its 2010 commodity exposure, except for PET, and management noted that it may increase prices if necessary to maintain margins in 2011.

COMPANY DESCRIPTION

Coca-Cola Enterprises, based in Atlanta, is a leading bottler in Western Europe and the world's third-largest independent Coca-Cola bottler. The company is the sole licensed bottler for Coca-Cola products in Belgium, France, Great Britain, Luxemburg, Monaco, the Netherlands, Norway, and Sweden.

VALUATION

We believe that CCE shares are fairly valued at 13.9-times our 2010 EPS estimate and 12.2-times our 2011 estimate, compared to a recent historical range of 9-16. Although we believe that the shares could move to the high $20s over the next year, such a gain is largely in line with our expectations for the broad market. As such, we are maintaining our HOLD rating.

On November 4, HOLD-rated CCE closed at $24.40, up $0.55. (Erin Ashley Smith, CFA, 10/4/10)

SPRINT NEXTEL CORP. (NYSE: S, $4.09) .... HOLD

S: Reiterating HOLD following 3Q results

- Sprint Nextel reported relatively flat revenue, a lower OIBDA margin, and a wider net loss in 3Q10. Postpaid subscribers also declined.
- However, the news was not all bad, as the company again posted a gain in total subscribers.
- Sprint faces uncertainty in its partnership with Clearwire related to competition within the partnership, funding needs, and capital structure.
- We are widening our 2010 loss estimate to $1.08 per share from $0.92 and maintaining our 2011 loss estimate of $0.65 per share.

ANALYSIS

INVESTMENT THESIS

HOLD-rated Sprint Nextel Corp. (NYSE: S) reported relatively flat revenue, a lower OIBDA margin, and a wider net loss in 3Q10. Postpaid subscribers also declined. However, the news was not all bad, as the company again posted a gain in total subscribers. The company faces intense competition, especially in the high-value postpaid end of the market.

We are maintaining our HOLD rating on Sprint in light of competitive challenges and the uncertainty over partner Clearwire.

RECENT DEVELOPMENTS

Sprint Nextel recently reported third-quarter results. Revenue rose 1.4% year-over-year to $8.15 billion. Adjusted operating income before depreciation and amortization (OIBDA) fell 11% to $1.34 billion, and adjusted OIBDA margin fell 190 basis points to 18.1%. Management attributed the declines to increased subsidies as the company added subscribers. The net loss widened to $911 million or $0.30 per diluted share from $478 million or $0.17 per share in 3Q09. However, the company recorded an increased valuation allowance for deferred tax benefits, which widened the 3Q10 net loss by $365 million or $0.12 per share.

EARNINGS & GROWTH ANALYSIS

We are widening our 2010 loss estimate to $1.08 per share from $0.92 and maintaining our 2011 loss estimate of $0.65 per share. Due to its history of repeated annual losses, Sprint may no longer recognize net tax benefits from operating losses. Management forecasts a net tax expense of between 7% and 9% in 2010 on pretax loss.

Sprint lost another net 107,000 retail postpaid subscribers in 3Q10; however, the loss rate has continued to moderate on a sequential basis, as the company lost 228,000 postpaid subscribers in 2Q10 and 578,000 in 1Q10. The company added 644,000 total subscribers during the quarter, though these were mainly lower-value prepaid and wholesale subscriber additions. Another telling profitability metric is wireless OIBDA to service margin. Sprint's margins are in the mid- to high teens, well below Verizon's consistent industry-leading margins in the mid-40s and AT&T's in the high 30s to low 40s.

We think Sprint has been successful in the growing prepaid market with the relaunch of its Boost brand last year and the acquisition or launch of several other brands, including Virgin Mobile and Assurance Wireless. Assurance Wireless is now in 11 states and will expand to 20 states by year-end. Most of Sprint's competitors are smaller regional companies like MetroPCS and Leap. The other majors also offer prepaid plans, though their focus is clearly on the more lucrative postpaid market. While prepaid is a lower-margin business than postpaid, prepaid is probably the strongest part of Sprint's business. As such, we believe that it may offer a strong future opportunity for the company despite its low margins.

With its much touted "4-G" Wi-Max service rollout, Sprint has also returned to compete in the lucrative smartphone segment of the market. In June, Sprint introduced the EVO 4G handset from HTC, which runs on Google's Android operating system platform. Though the handset has suffered from the same supply problems that have recently hampered handset launches throughout the wireless industry, and its launch was quickly overshadowed by the iPhone 4 in late June, we think the EVO handset has been solid performer for the company.

The Clearwire deal is perhaps CEO Dan Hesse's boldest move and largest gamble so far. Sprint turned all of its Wi-Max assets over to Clearwire in the hope that Clearwire would do a better job of managing the network buildout. However, Clearwire's rollout has been slow and oriented toward smaller markets, squandering the early-mover advantage in next generation 4-G that Sprint might have exploited. In addition, Clearwire has set up its own competing retail service and is probably taking subscribers that would ordinarily go to Sprint.

SAMPLE

FINANCIAL STRENGTH & DIVIDEND

Our financial strength rating for Sprint Nextel is Low, the lowest rank on our five-point scale. Sprint has $1.76 billion in current debt and $2.75 billion due in 2012. Management has been in cash-conservation mode for some time now, building reserves and amending its credit agreement. Cash & equivalents increased to $4.67 billion at the end of 3Q10, up from $3.9 billion at the end of 2009. Free cash flow was $1.6 billion in the first nine months of 2010, down 25% year-over-year due primarily to a substantially greater net loss, though capex also increased. Sprint's debt/total capital ratio rose to 56.5% at the end of 3Q10 from 53.8% at the end of 2009 as debt fell by $763 million but net losses reduced shareholders' equity. The rating agencies give Sprint debt ratings in the mid-B's, speculative junk with negative outlooks.

Sprint suspended its quarterly dividend in February 2008, and we do not expect it to be restored. We also do not expect meaningful share buybacks in the near future.

MANAGEMENT & RISKS

CEO Dan Hesse has taken a number of bold steps to get Sprint back on track, acquiring Virgin Mobile and iPCS last year. In the Clearwire deal, Sprint hoped that Clearwire could manage the Wi-Max network buildout and keep the various parties in the venture happy; however, rumors have abounded about Sprint's unhappiness with the slow network buildout and Clearwire's decision to field its own retail service. While Sprint owns a majority of Clearwire, it is run as an independent company. Clearwire may need another round of financing within the next year, which may change the relationships between the various partners. Some have even speculated that Sprint may decide to take over Clearwire. We see this as a potential negative for the stock given Sprint's already extended balance sheet.

Sprint has struggled with customer acquisition and retention. Wireless telecoms live or die by these metrics, and failure to improve results is likely to have a serious impact on the company's profitability and share price performance. The company obviously stumbled with the Nextel integration, failing to achieve the integration of the two networks and cultures without significant customer defections.

Sprint also faces the risk of increasingly strong competition (the result of the mergers of Verizon with MCI, and SBC with AT&T) in the highly prized enterprise and long-distance markets. These markets have suffered in recent years from intense competition. They have also benefited from the award of large new government contracts (though Sprint was out of the running).

A final risk for Sprint, as with all telecoms, involves regulation. In the last few years, we have found that FCC rulings can change competitive conditions in telecom markets, and that these rulings have generally been more favorable to the "Bell" incumbents than to competitive carriers like Sprint.

COMPANY DESCRIPTION

Sprint Nextel is an integrated national wireless and long-distance telecommunications company. Sprint is organized into consumer, business and network-support divisions. The company completed its acquisition of Nextel in August 2005 and spun off its local wireline division in May 2006.

VALUATION

Sprint Nextel shares have traded in a range of $3-$5 over the past year and are currently trading near the midpoint of that range. The shares have risen 38% (from an under-$5 base) over the past year compared to a 14% increase for the S&P 500, though year-to-date performance has been fairly flat.

Sprint's collapsing earnings have made valuation using P/E unsuitable. The stock's enterprise value/EBITDA multiple of 5.2 is below the peer group average of 5.7 and the multiples of 6.0 for Verizon and 5.6 for AT&T, which we view as much stronger competitors. The trailing price/sales ratio of 0.37 is also below the five-year historical range of 0.73-1.0. We are maintaining our HOLD rating on Sprint in light of competitive challenges and uncertainty over partner Clearwire.

On November 4, HOLD-rated S closed at $4.09, up $0.02. (Joseph Bonner, CFA, 11/4/10)

SAMPLE

Argus Research is an independent investment research provider and is not a member of the FINRA or the SIPC. Argus Research is not a registered broker dealer and does not have investment banking operations. The Argus trademark, service mark and logo are the intellectual property of Argus Group Inc. The information contained in this research report is produced and copyrighted by Argus, and any unauthorized use, duplication, redistribution or disclosure is prohibited by law and can result in prosecution. The content of this report may be derived from Argus research reports, notes, or analyses. The opinions and information contained herein have been obtained or derived from sources believed to be reliable, but Argus makes no representation as to their timeliness, accuracy or completeness or for their fitness for any particular purpose. This report is not an offer to sell or a solicitation of an offer to buy any security. The information and material presented in this report are for general information only and do not specifically address individual investment objectives, financial situations or the particular needs of any specific person who may receive this report. Investing in any security or investment strategies discussed may not be suitable for you and it is recommended that you consult an independent investment advisor. Nothing in this report constitutes individual investment, legal or tax advice. Argus may issue or may have issued other reports that are inconsistent with or may reach different conclusions than those represented in this report, and all opinions are reflective of judgments made on the original date of publication. Argus is under no obligation to ensure that other reports are brought to the attention of any recipient of this report. Argus shall accept no liability for any loss arising from the use of this report, nor shall Argus treat all recipients of this report as customers simply by virtue of their receipt of this material. Investments involve risk and an investor may incur either profits or losses. Past performance should not be taken as an indication or guarantee of future performance. Argus has provided independent research since 1934. Argus officers, employees, agents and/or affiliates may have positions in stocks discussed in this report. No Argus officers, employees, agents and/or affiliates may serve as officers or directors of covered companies, or may own more than one percent of a covered company's stock.

SAMPLE