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Room to Grow

Industries With Potential

by Eric Butterman

You want to find stock study candidates — have you thought of looking at ones in growing subindustries?

A lot can happen in five years — of course, you wouldn't know it from looking at the large-cap indexes back in 2007. Because, well, they look very much like the numbers we see right now. How could we have been in a financial crisis and possibly on the brink of economic ruin, and here we are back to basically where we started? Well, most don't want the next five years to be about breaking even, regardless of what the most common indexes will do — and that may mean looking beyond the obvious and into the subindustries.

Looking Beyond the Obvious

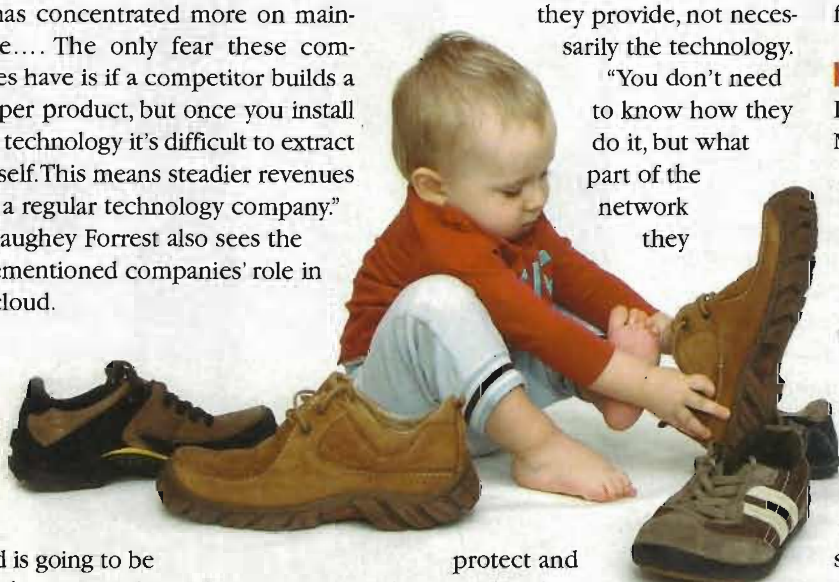
Many people find safety in the top players because everyone knows them. But, of course, a big problem can be — everyone knows them. Opportunities often come from "those other companies" flying under the radar, creating what consumers and businesses use but don't think of for investing. The clear example of this would be within technology. Kim Caughey Forrest, senior equity analyst at Pittsburgh-based Fort Pitt Capital Group and assistant manager for the Fort Pitt Capital Total Return Fund, says although the world may love social media and tablets, it's system and management software that could present the best opportunity.

"Everybody wants things to become simpler with the cloud, but the old technology sometimes never goes away, and the new stuff has to work with the old," she says. "System and network management allows both to work together, and if something breaks they'll fix it. It sounds simple but isn't — because of that, these vendors can extract a high amount of IT spend on the original technology."

Companies such as CA (ticker: CA) and BMC Software (BMC) understand the value they provide, she says. "If a company needs to run payroll, then it doesn't matter if you're now getting it via the cloud or smartphones, they still have to run payroll. These two companies are competitors but work in slightly different areas. BMC has made more of a success of selling help desk software, so if you call the help desk and your computer isn't working, they would log an event. CA has concentrated more on mainframe.... The only fear these companies have is if a competitor builds a cheaper product, but once you install their technology it's difficult to extract yourself. This means steadier revenues than a regular technology company."

Caughey Forrest also sees the aforementioned companies' role in the cloud.

"The cloud is going to be really big and partly not for consumers using apps, but for salespeople or some supply chain with information on a mainframe or older systems through the cloud," she says. "It will look like this hot mess of a map because we have new and old technology living together. Companies have software to ensure the old systems can exist with new systems in a secure environment and can monitor who's getting information from these systems. They're there at the end application as well and use their own software internally to deliver — so another company can't come in and find out what your service problems are."



Scott Kessler, head of technology sector equity research for S&P Capital IQ, believes the cloud's growth may very well reside in security. "It's about rerouting traffic in a way that lowers the potential for attacks, so companies such as Akamai (AKAM) and Centech have potential strongholds," he says. *(No investment recommendations are intended.)*

Another key area, Kessler says, is virtualization. "VMware (VMW) is looking strong in the category that they pioneered, a valuation that seems pretty reasonable to us," Kessler says. "But it is a competitive area where you have a lot of big established companies such as Oracle (ORCL)."

Overall, when it comes to subindustries in tech, Caughey Forrest says you have to understand the value they provide, not necessarily the technology. "You don't need to know how they do it, but what part of the network they protect and how quickly they turn value," she says. "You can see it in the press releases when it shows universities and companies deploying their technology and understanding the revenue that comes with it."

Flying High?

Caughey Forrest says her company also is bullish on providers for aerospace. "The developing world continues to get richer, and when they get to a certain financial level they'll want to fly around the world," she says. "Honeywell (HON) and Ingersoll-Rand (IR) can gain because they do the avionics — the computers that fly the plane. We also see Parker-Hannifin (PH) gaining since they do hydraulics — when the flaps come out and wheels come up, those are the parts that allow it to happen."

Many companies try to break into this market because it's significantly lucrative, Caughey Forrest says, yet it isn't such an easy trick. "A couple years ago, I saw a company make a presentation with a bag of bolts that looked like washers you could pick up at Home Depot," she recalls.

"The bolts in there were worth $10,000 because they were certified to exacting tolerances. Most people don't get why it would be so expensive. They don't understand how regulated this industry is to even be a parts supplier. This is an example where investors need to look at the barriers for entry."

Healthy Potential Returns

Lauren Migliore, an equity analyst at Morningstar, says subindustries in health that can fill a vital need continue to have a positive future. "Companies that focus on rare diseases will be well-positioned," she says. "Because there are very few patients, they can charge high prices for products. An example is Alexion (ALXN), which makes drugs for diseases that are deadly or have very serious side effects. You talk about the drug Soliris — it's the world's most expensive because of these reasons."

Still, regulatory pathways are more difficult to deal with than ever, Migliore warns. "For example, the FDA raised the bar for safety for diabetes," she says. "Now cardiovascular studies are needed to prove safety. The road to developing into something commercial is also tough. Most prominently, Dendreon (DNDN) had excitement as a cancer vaccine first, but has done badly."

Contract research is also an area within health for potential high growth. "We think that Ceros (traded

Don't Forget Insurance

Jeffrey Loo, an equity analyst at S&P Capital IQ, notes that if the health care reform law happens, many areas of business stand to benefit.

One aspect that stands out to him is health care service providers. "This could mean anywhere between 28 million to 32 million more Americans having health insurance," he estimates. "If you have a significant amount of people with insurance, that will likely require a greater amount of doctor visits. That would increase the number of customers for health care service provider companies — for example, clinical labs or a dialysis facility." Loo says Quest Diagnostics (DGX) and Laboratory Corporation of America (LH) could see a jolt. "The industry is growing in low- to mid-single digits — mature growth — but if health care reform continues, they should benefit because of the increase."

(For a table of health care companies, please see page 38.)

in overseas markets) stands to see favorable growth — and, remember, there are only a handful of firms in scale for clinical trials around the world so there aren't many options," Migliore says.

"Also, drugmakers want to do multiple regulatory approvals simultaneously, and if that becomes easier, it opens up opportunities for the stock," she says. "Charles River (CRL) is a company to look for.... Even though R&D overall is flat or even down last year, we think increased outsourcing and CRO (contract research organization) movement is something to look for to drive strong growth."

Jeffrey Loo, an equity analyst at S&P Capital IQ, says molecular diagnostics may be a term associated with growth down the road as well. "One of the issues is whether insurance companies will reimburse for molecular diagnostics tests, but I suspect they will," he says.

"There aren't too many sizable public companies in this space ,so the true players are Genomic Health (GHDX), Siemens (SI) and Abbott Labs (ABT).

"Tests will be particularly significant, since molecular diagnostics is based on DNA — like a personalized targeted medicine. Theoretically, these tests could better pinpoint somebody's illnesses or the test itself could determine if a particular therapy could be beneficial for an individual. When you consider how much money that could save in terms of helping a patient avoid heading down the wrong path, it could have huge implications."

Regardless of the subindustry an investor might choose, waiting five years requires patience. A drug may take a little longer to get to market. Technology will have its setbacks.

But for those who exercise patience, they might just find their chosen subindustry becomes an area of exponential growth. And maybe even tomorrow's industry. B