Chuck Jaffe

July 8, 2011, 12:01 a.m. EDT

Tellabs: good company, bad stock right now

Tellabs is a good company, but a bad stock right now

By Chuck Jaffe, MarketWatch

BOSTON (MarketWatch) — Ask most investors to make a list of the things they want from a company, and they'll say a solid balance sheet, solid business prospects and a bargain of a stock price.

Sometimes, however, those characteristics come together in a good company that, at least for a time, is a bad stock — one with more downside potential than up for the foreseeable future.

That's exactly the problem facing Tellabs Inc., a company that gives investors plenty of reasons for long-term optimism, but which has enough negatives in place to be the Stupid Investment of the Week.

Stupid Investment of the Week highlights the conditions and characteristics that make a security less than ideal for the average investor, and is written in the hope that spotlighting danger zones in one stock will make it easier for investors to avoid booby-traps elsewhere. While obviously not a purchase recommendation, neither is the column intended as an automatic sell signal.

That's particularly true in a case like Tellabs (NASDAQ:TLAB) , based in Naperville, Ill., which provides networking equipment that telecommunications companies use to manage voice and data traffic on their networks. From the standpoint of buying undervalued assets —— investing in a business and expecting long-term results, Tellabs can look pretty good; consider that Morningstar Inc. gives it a five-star rating, which signifies a buy.

Someone able to invest in the stock at its current discount levels — roughly $4.50 per share for a stock that most analysts say has a fair value of closer to $7 — and ignore the movements for a few years may well be rewarded for their patience.

Average investors, however, seldom look at stock purchases as buying assets, but rather look at it in terms of buying earnings, and what they can get out of the stock price in the short run. With Tellabs trading at 70 times forward earnings, the stock could get a lot cheaper before it realizes its potential, and studies show that typical investors bail out when a security loses 20% from the point where they buy in. Tellabs has significant potential to suffer that loss before building any recovery, and if the average investor gets out when it happens, they are losers even if the company proves the long-term investment premise and eventually returns to fair value.

A good balance sheet will help protect current investors; this is not about buying a downtrodden stock figuring it has nowhere to go but up, but rather is having financials that suggest this stock is on sale now.

What the financials can't say is whether you're getting the best "sale price" now.

"The stock is trading at a good asset value, but there are storm clouds that could make it drop from here," said Brent Wilsey of Wilsey Asset Management in San Diego. "It's the kind of stock where you have to believe going in that if it drops from $4.50 down to $2, that you like it enough to step in and buy more of it because you still believe you will be rewarded for owning these assets at a good price. Most people can't do that; they'll want to bail out."

Lacking the courage to stay put in the face of clear-and-present danger, Tellabs is a bad buy. Here's why:

- Tellabs' core business is facing a serious challenge. AT&T (NYSE:T) was the major customer for a certain multi-service router product, but the company — whose orders make up 35% of Tellabs' revenue — decided to upgrade its network using routers provided by competitors.
- AT&T and Verizon (NYSE:VZ) have made up half of Tellabs' sales for more than two years now. That kind of customer concentration is a big danger sign, and that sign is flashing red right now: Put the blame for the company's poor second-quarter revenue outlook squarely on the loss of income from AT&T, and consider what happens if that business contracts further.
- Even though the stock has been beaten back, dropping roughly 30% year-to-date, forward-looking valuations still seem pricey. Zacks Investment Research in Chicago has the stock trading at more than 130 times 2012 earnings estimates, which is more than three times higher than the industry average. (Zacks recently downgraded its rating on Tellabs to a sell.)
- While management is taking aggressive steps — ramping up research and development, expanding markets and more — you do have to question their record. David Trainer, president of New Constructs Inc., a Nashville-based research firm, noted that Tellabs looks cheap, but that's not enough to inspire confidence when management "has written off over $1.6 billion [after tax] of assets, 50% of the total assets of the company. That means for every one dollar of assets trusted with management, they lose or waste 50 cents, not exactly a good track record for value creation or capital allocation."

Supporters could say that companies tend to get leaner and do better once write-downs are finished, and that the revised picture is cleaner and easier to analyze once the garbage is off the books. That's why they can argue that Tellabs is a good long-term asset purchase, even if it's not a good stock right now.

David Brady of Brady Investment Counsel in Chicago noted that "There are a lot of good things going on at TLAB. For instance, the $350 million spent each year on R&D is worth digging into. For the analyst who is willing to roll up the shirt sleeves, there may be and quite possible is, something big on the horizon. "

That said, you not only need to be willing to roll up the sleeves, but to get dirty waiting for those items on the horizon to come into focus and pay off in the stock price.

That's the hard part about buying into a good company that's a bad stock. The investment could well pay off "at some point," but there's a real question as to whether average investors can suffer the indignities necessary to get from here to there.

Lacking that confidence — and it's hard to believe Tellabs could engender such optimism until after it resolves the issues with its biggest customer — average investors should look for bargains somewhere else.