

A Flash of Light in a Dimming Industry

By TIERNAN RAY

Shares of STEC can outgrow the company's disk-drive competitors.

IN THE MIDST OF THE IN THE MIDST OF THE worst downturn ever in the disk-drive business, there are still cutting-edge data-storage technologies that can grow rapidly and be highly profitable.

Those emerging technologies won't do much for the established disk-drive vendors, whose sales are too tied to traditional drive equipment to benefit much from niche products.

Instead, the spoils will mostly accrue to smaller specialty companies.

One such outfit is [STEC](#) (ticker: STEC), a \$356.5 million market-cap company based in Santa Ana, Calif. After 19 years of ups and downs selling something called a "solid state disk drive," or SSD, STEC is hitting its stride.

The stock is 50% off from its 52-week high, but has more than doubled since hitting its low in November.

STEC's disk drives are much faster than traditional spinning hard-disk drives and they use far less power. That's because they're made of flash memory chips, similar to those used in [Apple's](#) (AAPL) iPod.

STEC has a lock on the most expensive kind of drive, which it sells to [EMC](#) (EMC) and other makers of storage equipment for large corporations. Unlike disk drives, STEC's wares cost thousands, not hundreds, of dollars apiece.

The payoff is that STEC's little market is a lot more profitable than the rest of the drive business, something that could help its shares outperform in a market upturn.

STEC trades at 1.5 times this year's projected sales, and 16 times and 10 times this year's and next year's earnings per share -- modest multiples for a company that's expected to increase profits 45% this year.

While numerous companies sell storage containing flash chips to consumers, including [SanDisk](#) (SNDK) and Korean giant Samsung, STEC sells only to large storage-equipment makers like EMC, and in very small volume (it sold a mere 8,000 SSDs last year).

By wrapping a lot of complex circuitry around flash, STEC gets a high profit margin off its small volume of shipments.

STEC's gross profit is averaging 32% of sales, twice that of [Seagate Technology](#) (STX) and [Western Digital](#) (WDC), the world's Nos. 1 and 2 disk-drive makers.

SanDisk, meanwhile, made barely any money last year on all the flash drives it sells to consumers.

This year is expected to be the worst on record for the disk-drive business, with sales falling as much as 10% from 2008.

Western's and Seagate's corporate revenues are expected to fall 16% and 29%, respectively, this year.

In contrast, shipments of the kind of flash drives STEC sells are expected to climb 227% between 2007 and 2012, according to research firm IDC.

Numbers like that will get anyone's attention. And so on Monday, Western Digital paid \$65 million to buy privately held SiliconSystems, a competitor to STEC.

It's STEC's game to lose: The company is supplying just about all the top makers of storage equipment, including EMC, [Sun Microsystems](#) (JAVA), and Japanese computing giant Hitachi Data Systems.

Furthermore, deals with [IBM](#) (IBM) and [Hewlett-Packard](#) (HPQ) could be announced any day now. As a result, STEC's main product, the Zeus, saw sales climb 300% last year to \$53 million.

Analysts believe STEC holds the high ground in disk-drive performance, with as much as an 18-month lead on competitors.

"You will see other suppliers come into this," concedes B. Riley & Co. analyst Mike Crawford. "But I look at the design wins in the marketplace, and right now, this market is all theirs," referring to STEC.

"STEC will survive because they have solid technology," says John Monroe, an analyst covering the disk-drive market for research firm Gartner.

"The next really significant contenders are likely to be Intel and Hitachi," says Needham & Co. analyst Richard Kugele.

"But it's going to take them till early next year to come out with a competitive product [to STEC's Zeus], and then it's going to take them nine to twelve months to get it accepted by storage-equipment vendors."

STEC's 50-year-old co-founder, chief executive Manouch Moshayedi, an engineer who came to the U.S. from Iran in 1979, says the company's biggest advantage is the patents the company has related to flash-memory drives, as many as 60 awarded to date.

STEC has two in-house patent lawyers working constantly on new applications, says Moshayedi.

"The most important thing we are learning is all the things that haven't been patented; those are the most important little things," Moshayedi tells Barrons.com.

Seagate in April 2008 filed a patent infringement suit against STEC but dropped all charges last month with no confession of wrongdoing on STEC's part.

Little companies in a hot technology will always have competition, including really big companies with far greater resources.