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Seagate's 7.5% Yield Is Enticing

Investors have hammered disk-drive makers, but Seagate's fat dividend looks safe. Shares could return 20%.

By Alexander Eule
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Once upon a time, hard drives were the only way to store large files on personal computers. But the advent of the cloud means users don't have to store their own data anymore. The bits can sit in off-site data centers, delivered, when needed, via the Internet.

As a result, the market views hard drives as a fading memory. The main hard-drive makers, Seagate Technology (ticker: STX) and Western Digital (WDC), are down 38% and 54%, respectively, in the past 12 months.

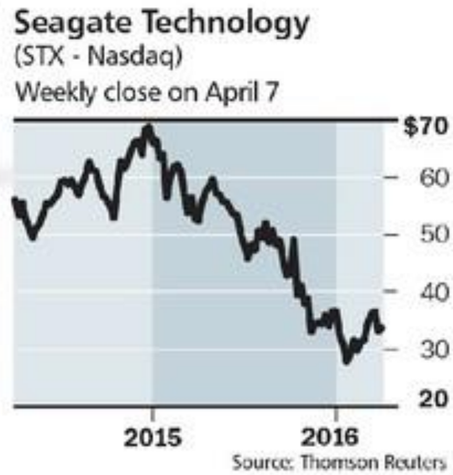
But cloud storage involves real digital bits, which need a place to live. As more of those bits move to data centers, massive hard drives will be in demand.

For now, though, cloud computing is hastening the decline of PCs, historically the core business for both Seagate and Western Digital. Earnings for both are expected to bottom out this year. After years of consolidating market share—Seagate has 40% of hard-drive sales, versus 44% for Western Digital, according to Gartner—the two companies are adopting divergent strategies.

Western Digital is buying SanDisk (SNDK) for $19 billion, giving it exposure to the still-growing market for flash memory, the type of storage that fills phones and tablets. The merger looks savvy, but Western Digital is paying a handsome premium for SanDisk, and the payoff could take time.

Income on a Silver Platter

Western Digital and Seagate are both cheap plays on the world's surging need for data storage. Both companies are being pressured by newer technologies, but Seagate's dividend more than offsets the risk.



Company/Ticker	Recent Price	Market Value (bil)	2016E EPS	2017E EPS	2017E P/E	Dividend Yield
Seagate Technology / STX	$33.11	$9.8	$2.76	$3.72	8.9	7.6%
Western Digital / WDC	43.25	10.1	5.88	6.46	6.7	4.6

E=Estimate. Fiscal years end in June. Source: FactSet

Seagate investors should benefit much sooner, thanks to the company's 7.6% dividend yield. The outsize payout looks safe, given Seagate's still-ample earnings and its commitment to cutting costs. Including dividends, the stock could return 20% or more in the next year.

But first, analysts expect Seagate earnings to bottom out at a seven-year low for the fiscal year that ends in June, to $827 million, or $2.76 a share, on $11.3 billion in sales. Earnings per share are forecast to jump 35% in 2017 on flat sales.

The company is essentially doubling down on hard drives, while buying back stock and paying dividends. Chairman and CEO Stephen Luczo recently offered a strong defense of the strategy.

"I still think the investing world isn't quite grasping the transitions around where storage is being stored," he told investors during the company's fiscal second-quarter call in late January. "From every source of data that we have, you still have 95% to 98% of bits ultimately being stored on a disk drive…So we like the overall storage business. And we particularly like the fact that we think the hard-drive business itself is going to benefit from the continued trend of more people being more connected, generating richer content."

A few days later, Luczo backed up the comments with his wallet, buying $6 million worth of Seagate stock. More often a seller than a buyer, Luczo paid about $30 a share, not far off a three-year low. Seagate has since rallied with the market, to a recent $33.

WALL STREET'S SELL-SIDE analysts remain lukewarm about Seagate's prospects. Just nine of 31 analysts rate the stock a Buy. There are legitimate concerns. Last month, UBS cut its price target on Seagate to $24, arguing that the full impact of lower PC sales and competition from flash was still not reflected in the stock. UBS rates Seagate at Sell.

But John Petrides, a portfolio manager at Point View Wealth Management, thinks the declining PC sales figures have overrun a good story in Seagate. "You have that one number that's throwing everything off," he says.

The Bottom Line

Seagate shares could rise 15%, to $38, or more, in a year. That, plus a solid 7.6% yield, makes the memory maker an attractive place to store some cash.

Contrary to the market's fears, newer flash drives, while faster, can't provide the scale or economics of hard drives. Flash still costs 27 cents per gigabyte of storage, versus four cents per gigabyte on hard disks, according to Gartner. Petrides thinks Seagate stock could rise to $38 over the next year, using a multiple of 13 times and a below-consensus EPS figure of $2.89. That gets the stock up 15% before the dividend.

Petrides is confident that the dividend is safe. While earnings estimates vary widely for next year, the lowest number is $2.75 a share. That's enough to cover the current dividend payout, which comes to $2.52 a year.

The company offered its own supportive signal in October when it boosted the dividend by 17%.

Needham analyst Rich Kugele, who has covered the hard-drive business for 15 years, thinks earnings could top $5 next year. He concedes that PCs are in a long decline, with more bad news still to come. But he views Seagate from a different perspective, focusing on its significant cost-cutting and a move to higher-margin, enterprise-focused hard drives—the massive drives that offer four to 10 terabytes of storage for data-center use. He rates Seagate a Buy with a $47 price target.

DATA IS GROWING 30% to 40% a year, Kugele notes. "Most of that ends up not being stored today," he says. As one example, he points to the massive amounts of weather data that have been lost to history. There was no reason to keep the raw data because there was no use for it. But the Big Data trend, and the associated analytics, pushes companies to keep the data since it can now be scanned for patterns and other business insights.

"Until we all find a way to stop generating data, I don't see a way to stop the need for hard drives in the data center," Kugele says.

In time, the cloud could still make it rain for Seagate investors.