

DRAMs Boost Chip Growth 2Q But 3Q Guidance is Soft and Risk Remains to the Downside

Overall semiconductor industry business conditions are expanding around a range of historical seasonal norms. However, the industry does not seem to be getting any kind of meaningful boost from a cyclical recovery or overall macroeconomic conditions that I would describe as ‘fragile.’ And against this backdrop, the sector has enjoyed a nice rally and outperformed broader equity markets so far this year. I continue to recommend picking individual stocks rather than trying to capture thematic trends in this environment. Specifically, stocks with both favorable business situations and share price valuation fundamentals, in my opinion.

Sleepy June Strength: June was subdued, as usual—albeit to the upside. Chip industry statistics for world-wide sales released by the Semiconductor Industry Association (SIA) earlier this month reflected a three-month rolling average gain of +0.8% compared to average growth of +0.4% with a high of +5.3%, a low of -9.2%, and declines 11 times over the last 23 years—including during five of the last eight. The Americas lead with growth of +3.5% followed by Asia-Pacific at +0.4% and Europe at +0.1%. Japan lagged with a decline of -0.9%.

Next month’s release of July data usually reflects an up-tick. It has averaged a gain of +1.2% with a high of +5.4%, a low of -6.3%, and has declined only five times in the last 23 years—but that includes both of the last two years.

Above-Average 2Q: 2Q growth bettered both expectations and its average, thanks to DRAMs. Industry statistics reflected solid growth of +6.0% against a 2Q average gain of +3.8% with a high of +20.0%, a low of -19.9%, and only five declines in the last 23 years, although three of those occurred over the last eight years. Tokeneke Universe guidance from 1Q earnings called for a near-average gain of +4.3% with a range of +1.4% to +7.2%, although reported company results on a weighted-average basis reflect +5.4% as of this writing with only a handful of announcements remaining, up from +4.9% after the third week of earnings season.

So why is my Universe underperforming to semiconductor industry statistics? Because DRAMs are under-represented: only Micron is included, while Samsung, Hynix and Elpida are not. Note recent DRAM market price strength as noted in the chart on Page 5 of this report (as well as my bullishness on Micron and its recent acquisition of Elpida). The good news is that DRAMs are driving industry upside; but the bad news is how few players are benefiting from it.

Weak 3Q Outlook: Notwithstanding the under-representation of DRAM suppliers, the 3Q outlook for growth is below average based on management guidance during 2Q earnings season. With 2Q earnings announcements largely complete, the Tokeneke Universe is anticipating 3Q growth around +4% compared to the historical average just over +6%. Specifically, the weighted average based on management guidance is currently centered around +4.3% with a range of +1.1% to +7.5%, while the average since 1990 is +6.3% with a low of -11.7%, a high of +19.9%, and declines only twice in 23 years.

As I noted last month: the worldwide economy remains fragile; PC markets have deteriorated off of no-growth expectations; consumer markets are being cannibalized by smartphones (think digital cameras); and higher-growth expectations for both China (in general) and smartphones and tablets (in particular) have tempered. I expect 3Q sequential growth across the semiconductor industry to be supported by new video game platforms, continued strength from automotive and industrial markets, persistent inertia from smartphones and tablets, and possible incremental gains from communication infrastructure and PCs. Unfortunately it appears growth may fall short of seasonal norms largely due to weak macroeconomics and PC markets. Also, recall that most market researchers expect chip industry annual revenue growth in the low- to mid-single digit percentages.

July Rally Underperforms: Semiconductor sector stocks rallied during July, but underperformed broader equity markets. The Philadelphia Semiconductor Index Option (SOX) grew by +2.0% last month and the average stock in the Tokeneke Universe gained an even-better +5.4% with 69 out of 101 advancing. This compares to broader equity market gains in the NASDAQ, S&P500 and DOW of +6.6%, +4.9%, and +4.0%, respectively. Year-to-date through July the SOX was up by +24.4% with the average stock in my Universe up by a similar +24.8% with 78 posting

gains, compared to those same three indices with gains of +20.1%, +18.2% and +18.3%, respectively. However, chip sector has been underperforming to declining equity markets so far during August.

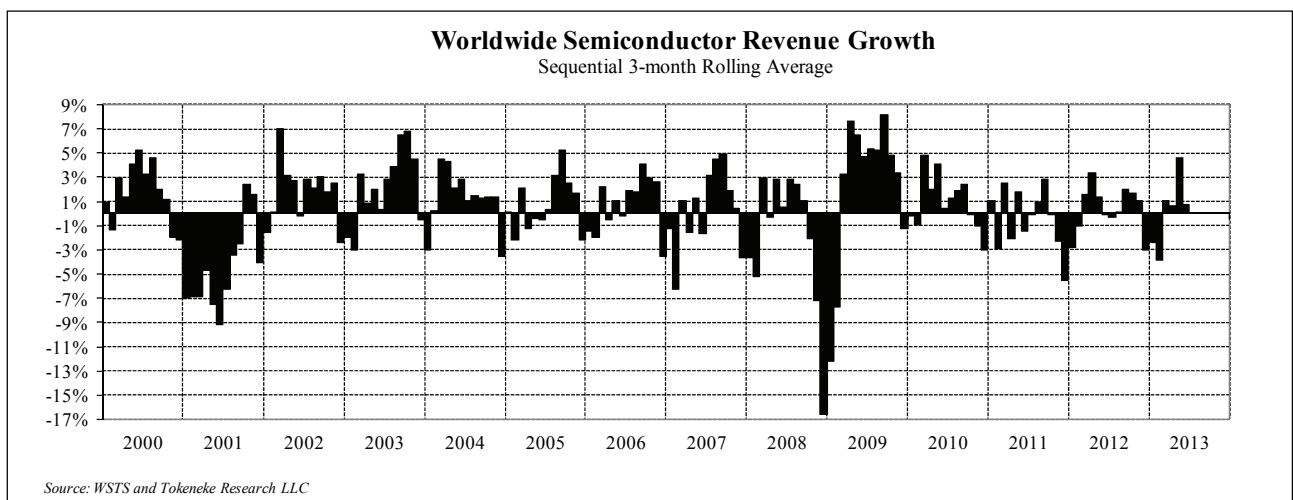
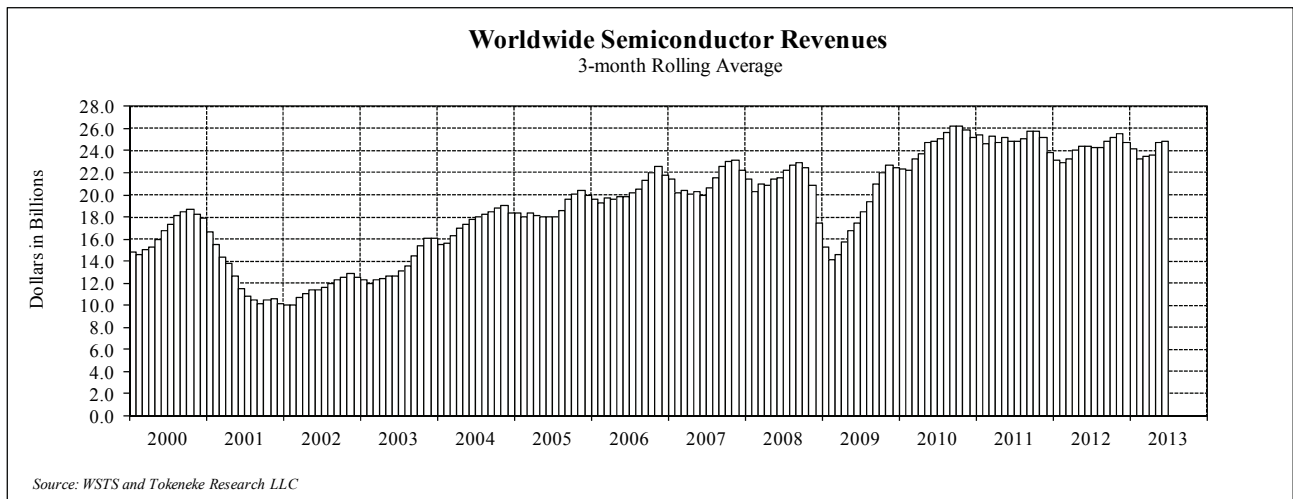
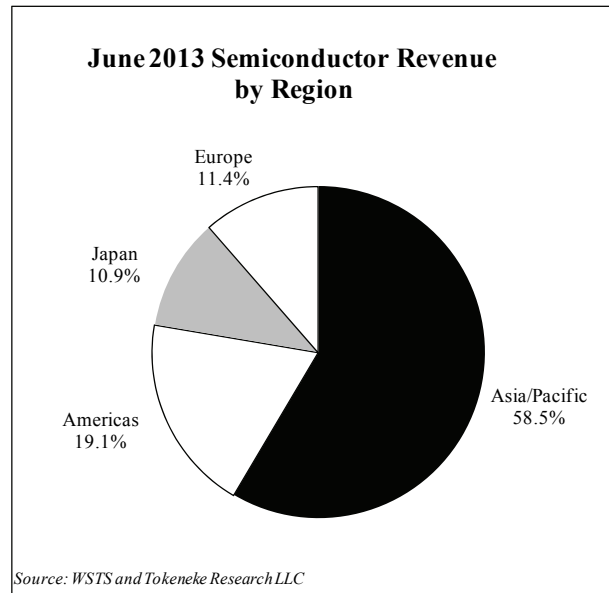
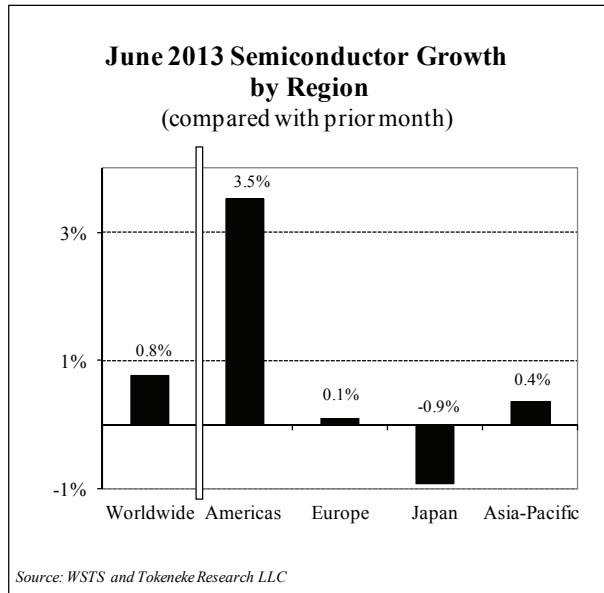
July				YTD				Indices		
Winners (69/101)		Losers		Winners (78/101)		Losers			Jul	YTD
POWI	36.0%	BRCM	-18.4%	SPWR	392.0%	TSEM	-42.3%	SOX	2.0%	24.4%
AMCC	34.9%	IKAN	-14.1%	HIMX	171.3%	MSPD	-34.4%	SMH	2.3%	19.3%
SPWR	33.6%	SMTC	-13.6%	MU	108.8%	CRUS	-33.4%	NASDAQ	6.6%	20.1%
SQNS	31.1%	OVTI	-12.9%	RMBS	100.2%	GIG	-30.4%	S&P500	4.9%	18.2%
ISIL	30.9%	IDCC	-11.0%	INFN	87.8%	TXCC	-29.5%	DOW	4.0%	18.3%
average stock +5.4%		SOX +2.0%		average stock +24.8%		SOX +24.4%				

Keep Picking Stocks: Overall semiconductor industry business conditions are expanding, albeit around the range of historical seasonal norms. However, the industry does not seem to be getting any kind of meaningful boost from a cyclical recovery or overall macroeconomic conditions that I would describe as ‘fragile.’ And against this backdrop, the sector has enjoyed a nice rally and outperformed broader equity markets so far this year.

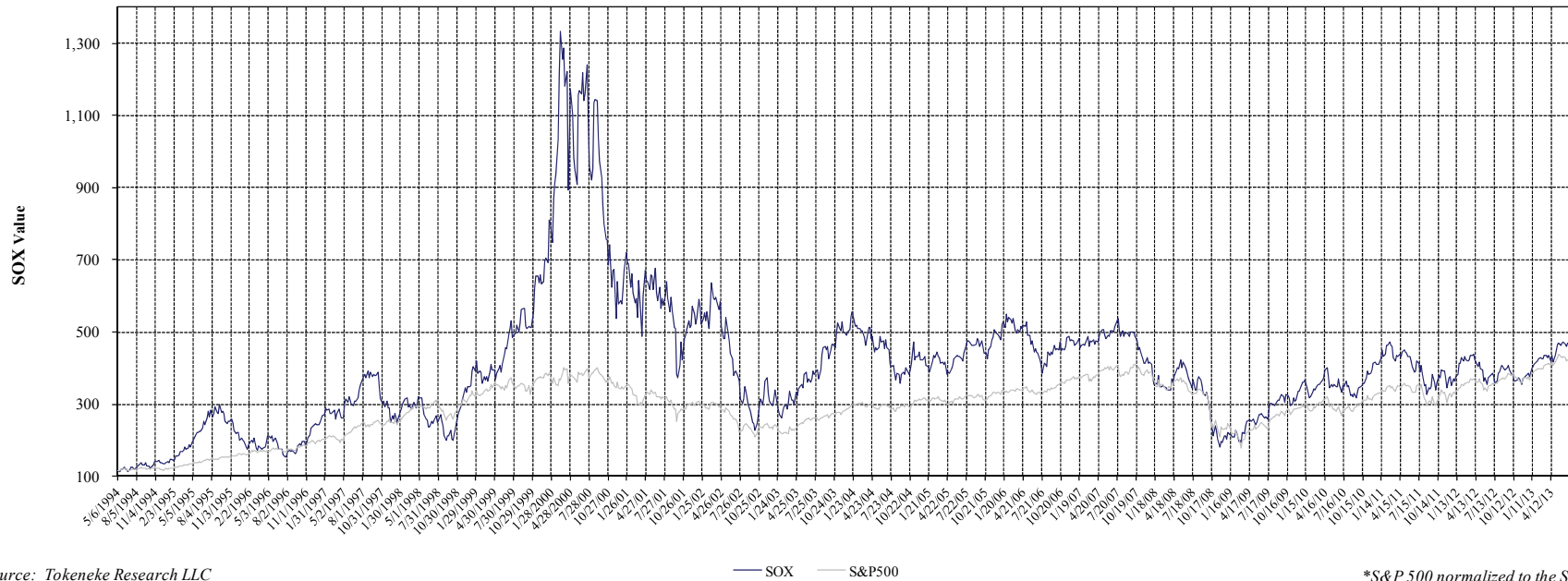
So how does an equity investor entertain the semiconductor sector in this kind of environment? Short answer: pick stocks. Specifically, stocks with both favorable business and share price valuation fundamentals, in my opinion.

Skew the Odds in Your Favor: Semiconductor industry business conditions are growing modestly amid a diverse collection of end-market strengths and weaknesses. While the risk-reward trade-off has shifted unfavorably so far this year following the rally across the sector, attractive investment opportunities continue to exist as noted in my latest Chip Investment Ideas publication, in my opinion. I recommend to carefully pick stocks with pronounced attractive fundamental valuations to mitigate potential downside risk—but only so much as discomfort will allow for your particular situation.

—Dan K. Scovel
Semiconductor Analyst

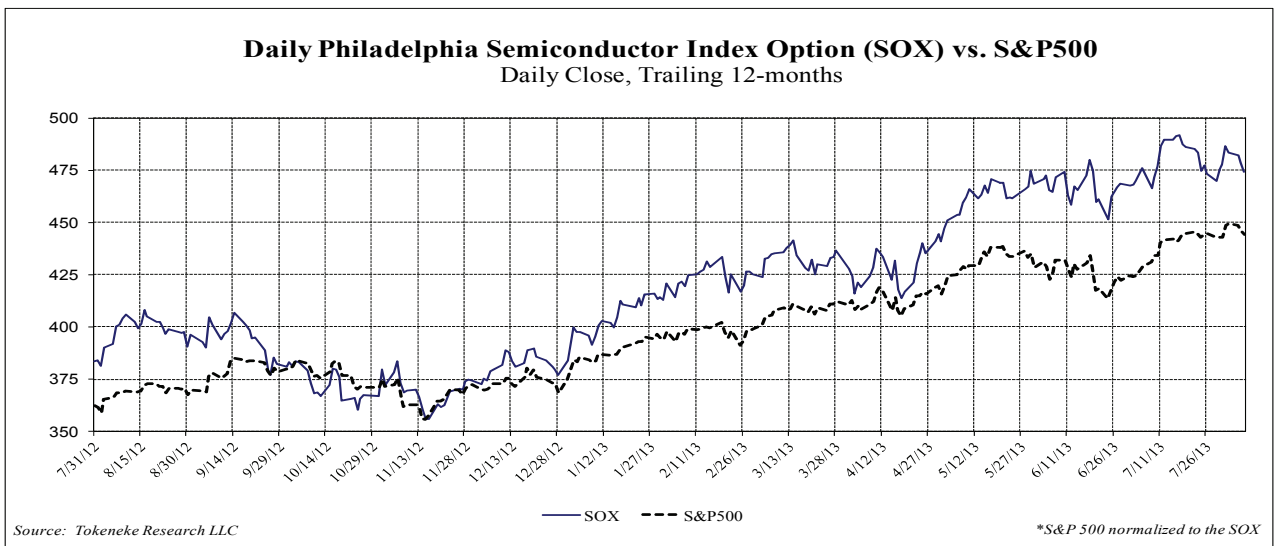
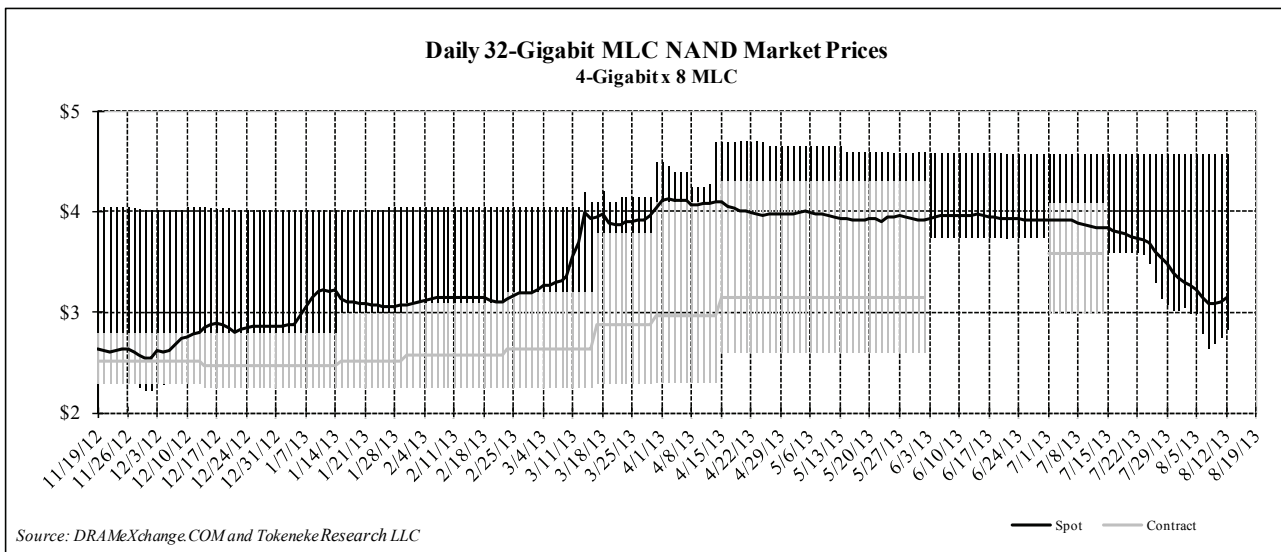
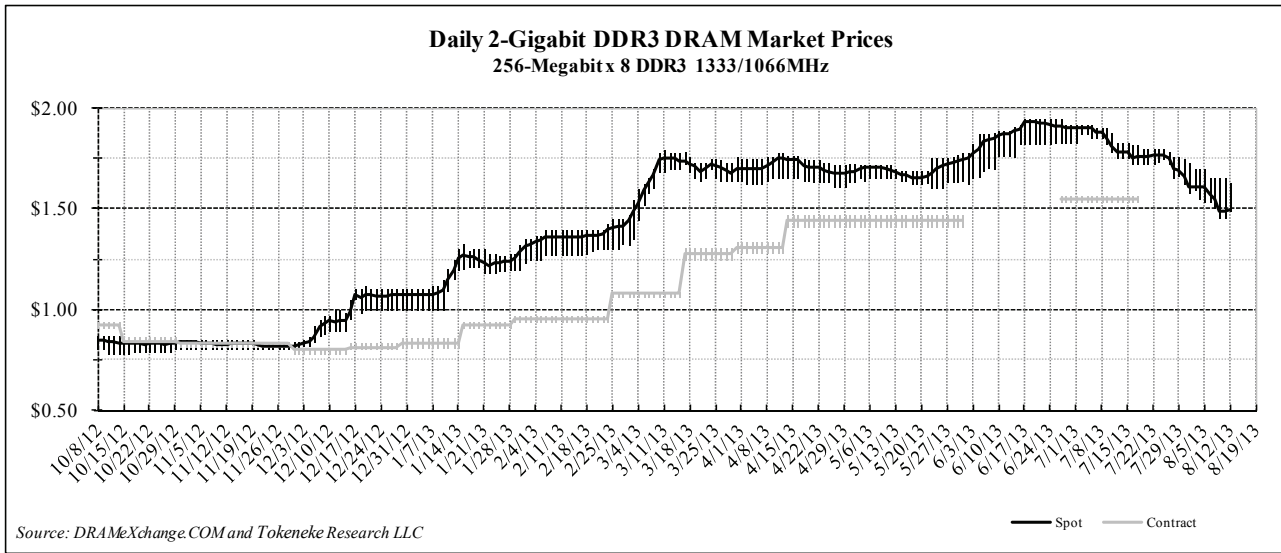


Weekly Philadelphia Semiconductor Index Option (SOX) vs. S&P 500



Source: Tokeneke Research LLC

*S&P 500 normalized to the SOX



The Company

Tokeneke Research is an independent research firm specializing in semiconductor industry business issues, providing fundamental research focused on US equities across all market capitalizations within the sector to investors. The company was founded in 2005 and is based in Connecticut.

The Offering

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My Background

I have an electrical engineering background, nearly 12 years of semiconductor industry experience, and was on Wall Street for nearly eight years where I was selected as the Best On The Street semiconductor analyst for 2002 by The Wall Street Journal, and third-rated Best of the Best across all sectors.

I obtained my undergraduate BS degree in electrical engineering from the University of Washington, and my MBA from Santa Clara University. My industry experience consists of nearly 12 years in various technical sales and marketing roles at four different semiconductor firms located in Silicon Valley beginning with Advanced Micro Devices in 1984, followed by two small start-up companies, and ending at Cirrus Logic where I supported the firm's Japanese market development. I joined Fahnstock & Co. as a senior semiconductor analyst in 1996 and was recruited by Needham & Co. in April 2000.

My formal coverage list as a sell-side analyst included the following equities: AMD, ALSC, ALTR, ARTI, ATML, CUBE, CY, ESST, GNSS, INTC, ISSI, LSI, MOSY, MU, OIIM, OVTI, RMTR, SIII, SMSC, STEC, SVTG, TDFX, TSRA, TXN, and ZRAN.

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