

## Surprising 3Q Strength, and Equities Rally But 4Q is in Retreat. Risk Remains to the Downside.

Uninspiring business conditions across the semiconductor industry are now clearly softening as share prices mostly rally—but don't consistently outperform on a relative basis. As a fundamental analyst, this makes me very uncomfortable. While I consider the risk-reward trade-off to be largely unfavorable from a macro perspective at this point, I also believe a few specific stock picks remain attractive—but only so much as discomfort will allow.

**Average September:** Worldwide semiconductor industry revenue growth for September was very close to average. Statistics released by the Semiconductor Industry Association (SIA) last week reflected a three-month rolling average gain of +3.3% compared to average growth of +3.1% with a high of +8.2%, a low of -2.5%, and only one decline over the last 23 years. The Americas returned to the lead after two months with growth of +5.7% followed by Japan sliding into second place with +3.8% and Asia-Pacific at +2.7%. Europe trailed with growth of +1.7%.

Next month's release of October data is usually slightly less robust: it has averaged a gain of +2.5% with a high of +6.8%, a low of -2.0%, and has declined only 3-times in 23 years—but all of those occurred within the last 5-years.

**3Q Upside:** Industry statistics reflect 3Q sequential growth at +8.4% which is much greater than average, expected, and reported to-date at +6%, +4%, and +6%, respectively. The semiconductor industry has averaged a 3Q gain of +6.3% with a high of +19.9%, a low of -11.7%, and has declined only twice in the last 23 years. Guidance from 2Q earnings called for a below-average gain of +4.4% with a range of +1.2% to +7.5%, and preannouncements slightly lowered the mid-point to +4.1% and narrowed the range to +1.4% to +6.8%. Preannouncements totaled 13 and skewed negative with 5 lowering guidance (ACTS, CEVA, CY, IDCC, and RDA), 7 reiterating or narrowing the range (BRCM, DIOD, MCHP, MSCC, SIMO, TSM and TXN), and only one slightly raising expectations (UMC).

With 85 out of 99 companies in the Tokeneke Universe reporting after the fourth week of the 3Q earnings season, the cumulative weighted revenue growth is +6.1% which is up considerably from the prior week's +3.5% and towards the high-end of the range of guidance—but still well below that +8.4% SIA number. Why? First of all, the Tokeneke Universe sales at \$55.4B only accounted for just over 72% of SIA sales during 2Q13. Secondly, my Universe does not include big international chip suppliers (Samsung, Toshiba, SK Hynix, Renesas, Infineon, Sony and MediaTek), but does including wafer foundries (SMI, TSM, TSEM and UMC), IP companies (CEVA, EZCH, IDCC, RMBS and TSRA) and others (NLST, SPWR and VIMC) that are technically not semiconductor industry revenue contributors. And third, there are still some billion-dollar-in-annual revenue companies that have yet to report 3Q results (ADI, AVGO, DIOD, MRVL, OVTI and SPRD). Last quarter my Universe caught up to the SIA industry growth rate as earnings season drew to a close.

Over the last few months: the worldwide economy has been fragile; PC markets have deteriorated off of no-growth expectations; consumer markets were cannibalized by smartphones (think digital cameras); and higher-growth expectations for both China (in general) and smartphones and tablets (in particular) tempered. My expectations for 3Q sequential growth have been largely supported by continued strength from automotive and industrial markets, new video game platform introductions, persistent inertia from smartphones and tablets, as well as gains from communication infrastructure markets. However, it appears that growth did NOT fall short of seasonal norms as I feared it might due to weak macroeconomics and PC markets.

**4Q Downside:** The 4Q outlook based on management guidance is now calling for a sequential decline across the semiconductor industry of -1.5% which is well below historical average growth of +1.5%. The chip industry has averaged a 4Q sequential gain of +1.5% with a high of +16.6% and a low of -24.2%, but has been negative nine times in the last 23 years including five of the last six years. The specific range of weighted sales from my Universe after the fourth week of the 3Q earnings season calls for a decline centered at -1.4% ranging from -4.3% to +1.4%, although it has been improving by a few-tens-of-basis points as the season has progressed.

**Chip Sector Rally Underperforms:** Semiconductor sector stocks rallied, but underperformed compared to broader equity markets last month—although it was a pretty rocky ride throughout the period. The Philadelphia Semiconductor Index Option (SOX) gained +3.3% last month, although the average stock in the Tokeneke Universe grew by only +1.1% with a mere 47 out of 98 advancing. This performance largely fell short of broader equity

market gains from the NASDAQ, S&P500 and DOW of +3.9%, +4.5%, and +2.8%, respectively. Year-to-date the chip sector is maintaining its outperformance: the SOX is up by +32.0% with the average stock in my Universe up by a similar +28.6% with 73 out of 98 posting gains, compared to those same three indices with gains of +29.8%, +23.2% and +18.6%, respectively.

October				YTD				Indices		
Winners (47/98)		Losers		Winners (73/98)		Losers			Oct	YTD
QUIK	46.4%	TXCC	-21.2%	SPWR	437.5%	TXCC	-66.4%	SOX	3.3%	32.0%
VIMC	40.4%	CEVA	-16.9%	HIMX	303.1%	PSMI	-46.8%	SMH	3.2%	27.3%
IXYS	20.5%	STM	-16.6%	MU	178.9%	TSEM	-39.4%	NASDAQ	3.9%	29.8%
CODE	18.6%	SQNS	-15.9%	PXLW	102.2%	MLNX	-38.9%	S&P500	4.5%	23.2%
MOSY	18.3%	EXAR	-14.0%	AMBA	84.3%	MSPD	-38.2%	DOW	2.8%	18.6%
average stock +1.1%				SOX +3.3%		average stock +28.6%		SOX +32.0%		

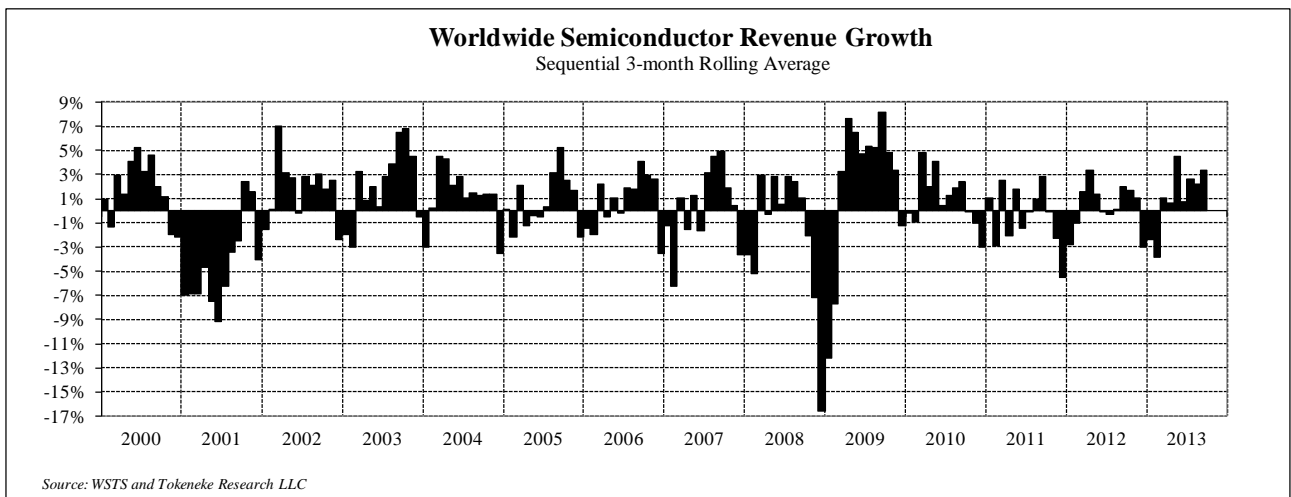
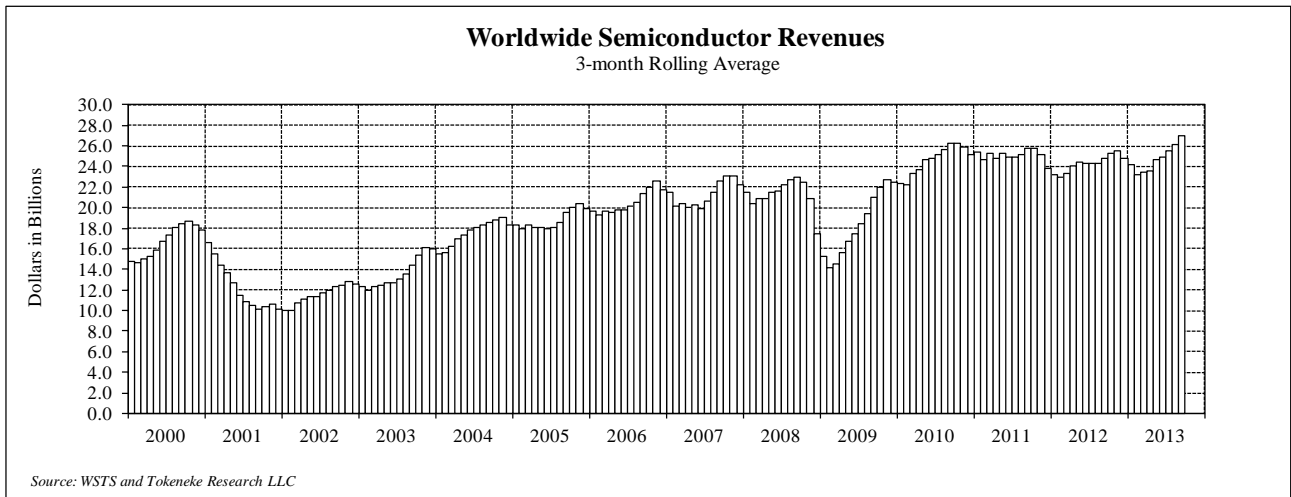
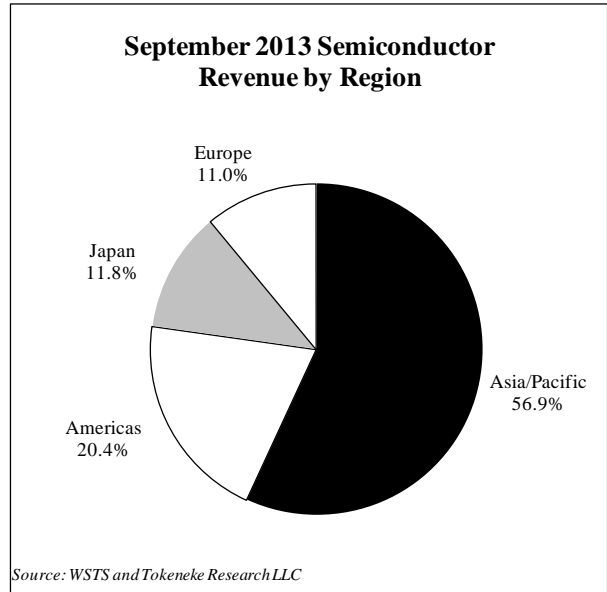
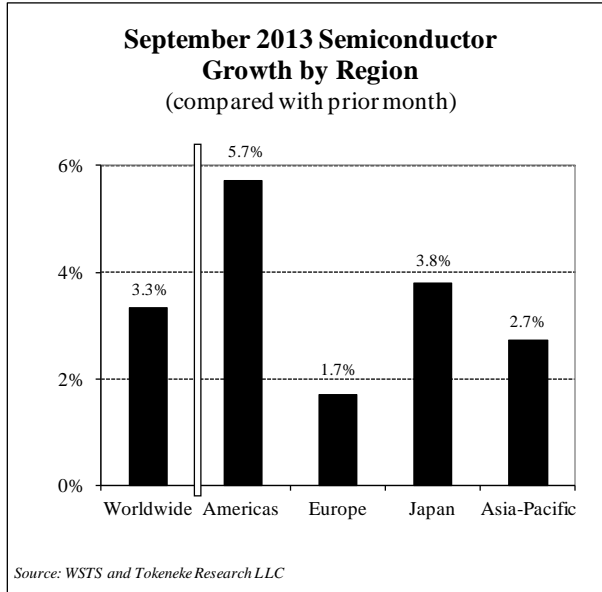
**Roller Coaster Year:** Both business conditions and share prices have experienced a roller-coaster ride so far this year. Chip industry business conditions began the year on a low note with a promise of accelerating gains into the second half. Then 3Q guidance for growth at the beginning of the period disappointed more optimistic expectations. Now 3Q results appear to have significantly exceeded that disappointment—but 4Q guidance calling for decline is even more of a disappointment.

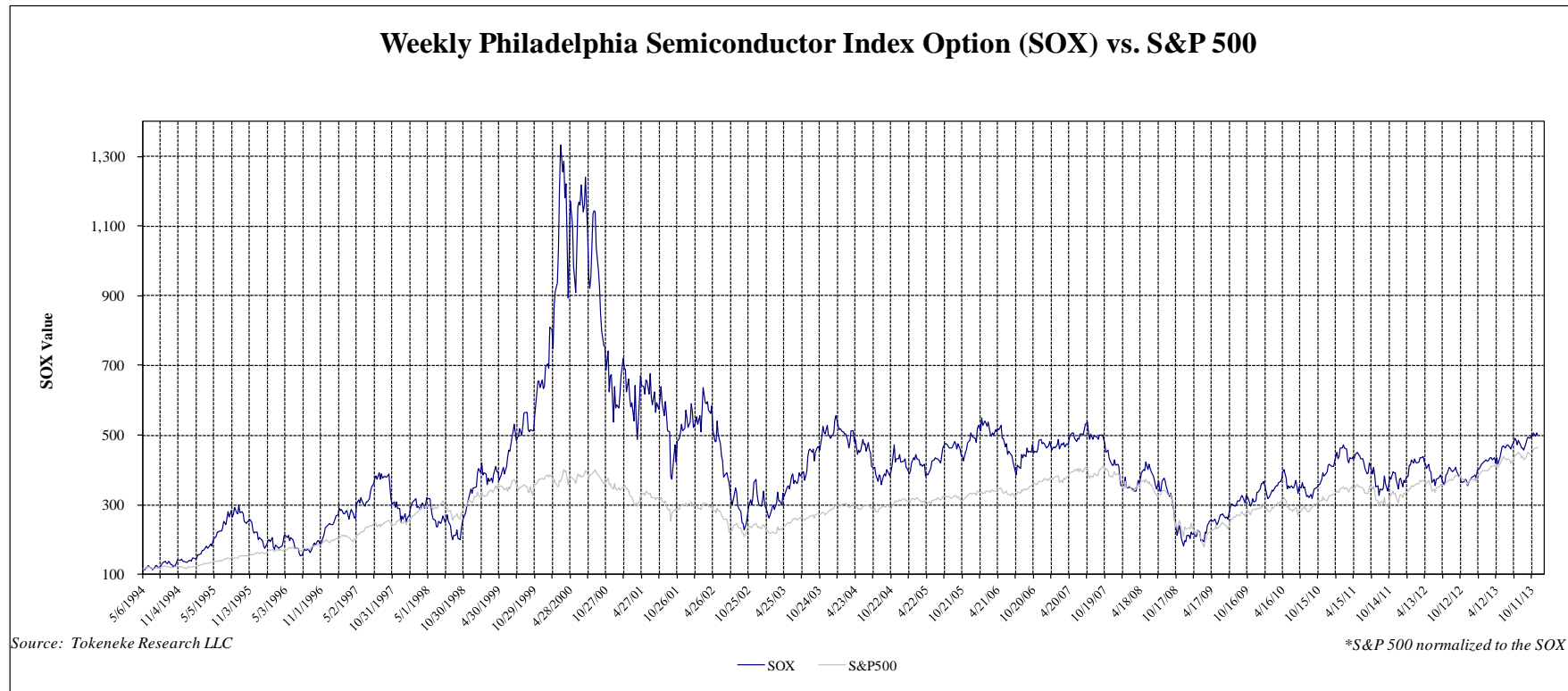
Semiconductor sector shares, on the other hand, rallied nicely during most of the first half of this year and have largely maintained their advantage on a relative basis despite monthly oscillations of gains and losses that began mid-year, as well as outperformance and underperformance compared to broader equity markets that began in March. The easy money was made during 1Q, but it has been a fairly rocky ride since then—not unlike the oscillations between investor expectations and reported results.

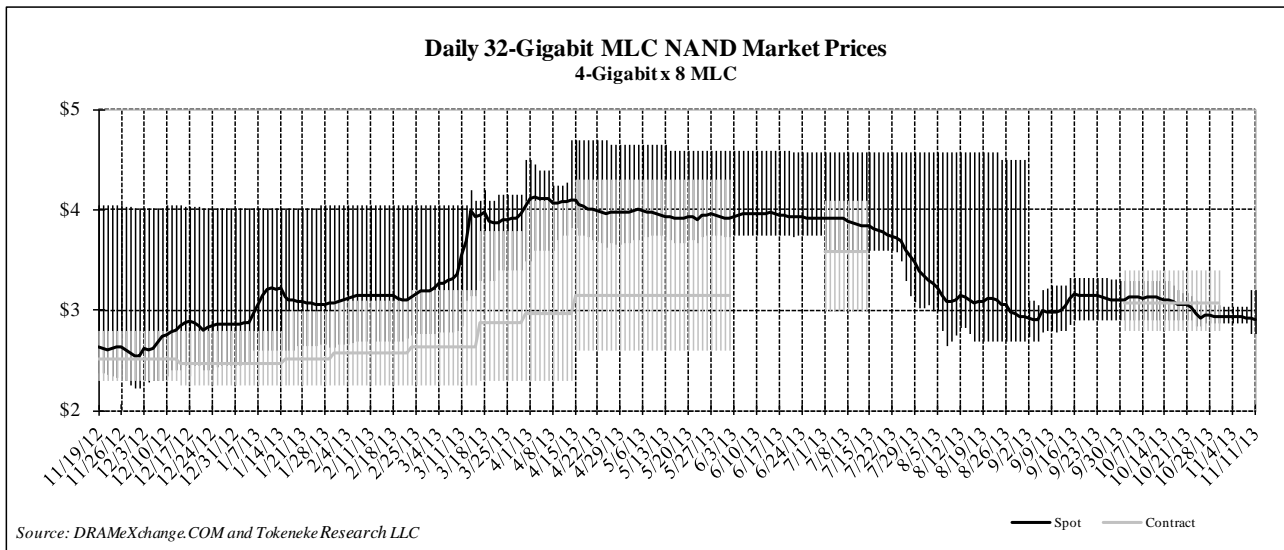
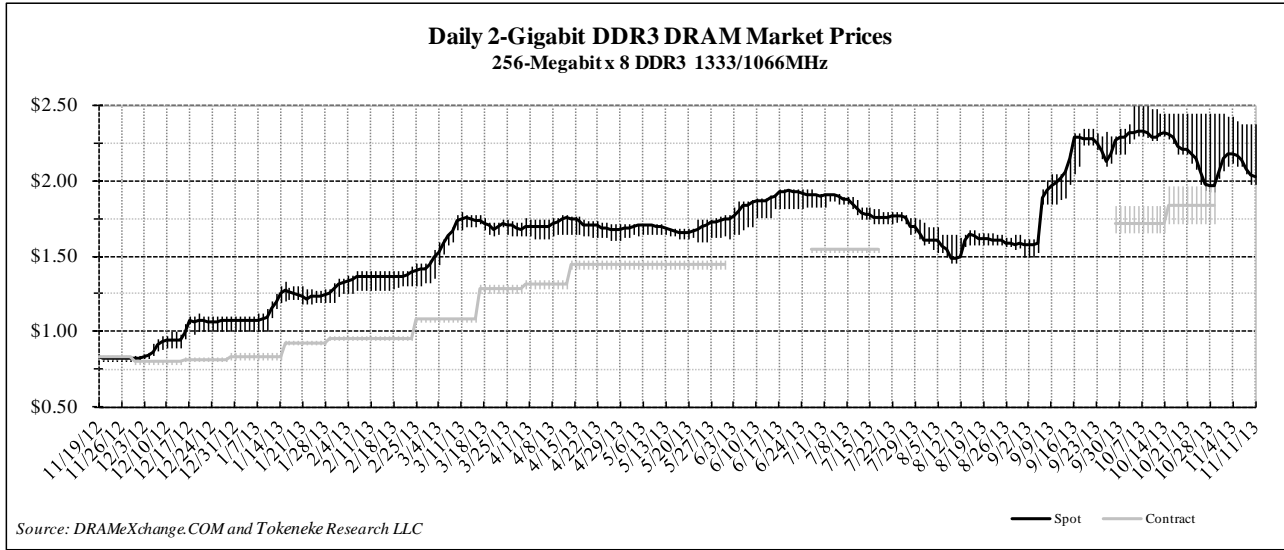
**Take the Money and Run:** This equity market environment scares the crap out of me. Yes, I understand equities are favored across a smorgasbord of unattractive alternatives. But uninspiring business conditions are now clearly softening as share prices mostly rally—but don't consistently outperform on a relative basis. As a fundamental analyst, this makes me very uncomfortable.

The risk-reward trade-off is unfavorable at this juncture, in my opinion, and I think the chip sector is at risk of correction at a macro level. Nevertheless, I continue to recommend a few specific stocks with better than average growth prospects and highly attractive fundamental valuations that—combined—should mitigate potential downside risk. But, once again, such opportunities should only be addressed as much as discomfort will allow for an individual investor's appetite. I have been much more comfortable addressing specific stock picks for most of this year than I have been with respect to the sector overall, and that situation remains unchanged. See my latest Chip Investment Ideas publication for specifics.

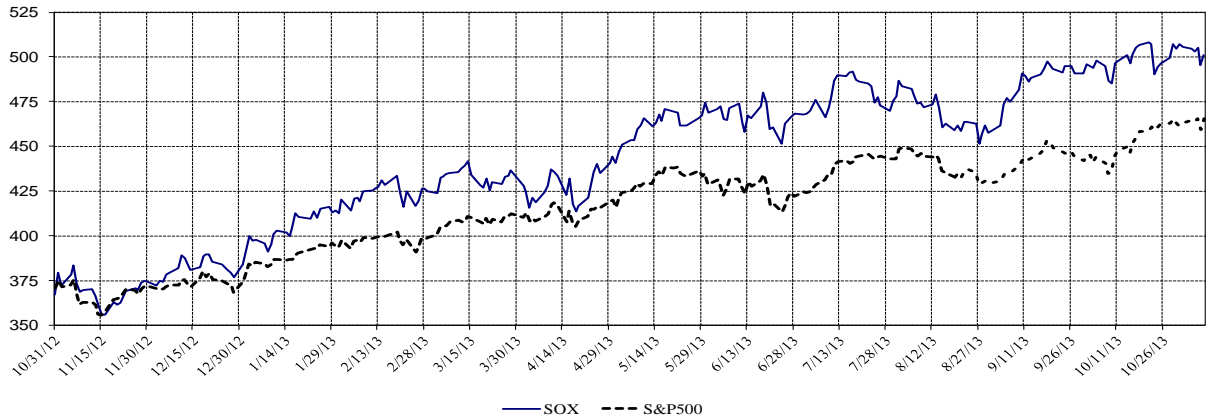
**—Dan K. Scovel**  
Semiconductor Analyst







### Daily Philadelphia Semiconductor Index Option (SOX) vs. S&P500 Daily Close, Trailing 12-months



## **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**

- *Monthly Newsletter:* A summarized review of noteworthy industry business developments, sales statistics, and sector equity market performance, as well as a near-term and annual outlook for sector business fundamentals and share prices. This report typically includes two pages of text and a handful of recurring charts and tables. It is intended for relatively broad-based distribution.
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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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