

The Mid-Year Semiconductor Blues

Stocks Correct as Second-Half Optimism Fades, But Opportunities May Emerge

The good news is that semiconductor industry business conditions exceeded expectations during the first half of the year and chip sector shares rallied and outperformed consistent with such fundamentals. The bad news is that emerging visibility to second-half business conditions are disappointing optimistic expectations and have triggered a more recent correction in share prices. But the best news is that this correction may well open up a number of investment opportunities consistent with both business and valuation fundamentals. Patience is a virtue, and opportunity may come knocking sometime soon.

Darn Good June: Worldwide semiconductor industry revenue grew by a much-better-than-average +2.6% sequentially during June, according to statistics released by the Semiconductor Industry Association (SIA) earlier this week. This compares to an average gain of +0.4% with a high of +5.3%, a low of -9.2%, and gains 11 times in the last 24 years—including five of the last ten. The Americas lead the pack with growth of +4.9% followed by both Asia-Pacific and Japan with gains of +2.1%. Europe brought up the rear with a respectable +1.9%.

Next month's release of July data usually reflects even better growth: it has averaged a gain of +1.3% with a high of +5.4%, a low of -6.3%, and declines only five times in the last 24 years—including only two of the last 10 years. I expect it to be well above average and could be as good as June, although probably not much better.

2Q Strength: Semiconductor industry statistics reflected an above-average sequential quarterly gain of +5.4% last quarter. However, weighted average industry revenue growth by companies in the Tokeneke Universe announcing 2Q earnings so far (with about two-thirds having reported) reflect an even more robust sequential gain of +8.0% with the average company up by +5.9%, ahead and consistent with guidance centered around +6%, respectively. All three metrics are well above the historical average approximating +4%.

Original weighted average management guidance from the Tokeneke Universe of companies for 2Q revenue finished at +6.1% sequentially and ranged from +3.3% to +8.9%, and 14 subsequent preannouncements slightly raised the mid-point to +6.3% and the range to +3.3% to +8.9%. Five of the 14 preannouncements reiterated or narrowed their ranges (ADI, BRCM, DIOD, SMI and UMC); another five raised guidance (IDCC, RMBS, SIMO, SWKS and TSM); and four lowered it (ACTS, ANAD, ENTR and SIMG). The semiconductor industry has averaged a 2Q sequential gain of +3.9% with a high of +20.0% and a low of -19.9%, and has been negative only five of the last 24 years—including three of the last 12, according to industry statistics.

In addition, a (very) slight plurality of companies reporting 2Q earnings to-date have exceeded investor expectations. Specifically, companies reporting results that 'met/exceeded' expectations total 44%, the 'mixed' category follows closely with 43%, and only 13% are in the 'missed-met' category of losers. Recall this metric compares investor expectations to reported results for 2Q revenue and EPS, as well as 3Q revenue guidance.

3Q Underperformance: The 3Q outlook based on management guidance across the Tokeneke Universe so far is reflecting a slightly below-average seasonal gain of +5%. While this isn't bad, it appears to be falling short of investor's expectations for a more robust second half. The specific weighted average guidance for revenue is currently centered at +4.7% ranging from +1.7% to +7.7. The semiconductor industry has averaged 3Q sequential revenue growth of +6.4% with a high of +19.9% and a low of -11.7%, and has declined only twice in the last 24 years—including none of the last 10.

Chip Stocks Correcting: Semiconductor sector stocks are correcting and underperforming relative to broader equity market weakness, although continue to reflect gains and outperform year-to-date. The Philadelphia Semiconductor Index Option (SOX) lost -4.5% last month while the average stock in the Tokeneke Universe fell by a comparable -5.0% with only 21 out of 92 issues advancing. This was even worse than broader equity market declines from the NASDAQ, S&P500 and DOW of -0.9%, -1.5%, and -1.6%, respectively. However, the chip sector is outperforming by a wide margin so far this year with the SOX up by +13.6% and 53 out of 92 Tokeneke stocks up by an average of +8.3% compared to those same three indices at +4.6%, +4.5% and -0.1%, respectively, as of the end of July.

July				YTD				Indices			
Winners (21/92)		Losers		Winners (53/92)		Losers		Jul		YTD	
MLNX	19.5%	QUIK	-34.2%	RFMD	116.3%	IKAN	-63.3%	SOX	-4.5%		13.6%
RFMD	16.4%	NPTN	-25.2%	TQNT	115.7%	HIMX	-56.5%	SMH	-1.5%		14.9%
TSRA	15.1%	AMCC	-22.8%	SWKS	77.7%	ANAD	-56.5%	NASDAQ	-0.9%		4.6%
TQNT	13.8%	ADNC	-20.3%	TSEM	73.1%	NPTN	-55.9%	S&P500	-1.5%		4.5%
SIMO	12.9%	RMBS	-19.5%	NLST	67.6%	ENTR	-40.6%	DOW	-1.6%		-0.1%
average stock -5.0%		SOX -4.5%		average stock +8.3%		SOX +13.6%					

2014 Is Looking Very Familiar: I'm sticking with my forecast for 2014 since the beginning of the year: Semiconductor industry business conditions will continue to grow at the slow pace and pattern established over the last couple of years with annual growth in the mid-single digit percent range. In fact, the profile of business this year is strikingly similar to that we saw in the previous three years, as optimism for a strong second-half after a weak start fades when mid-year visibility disappoints.

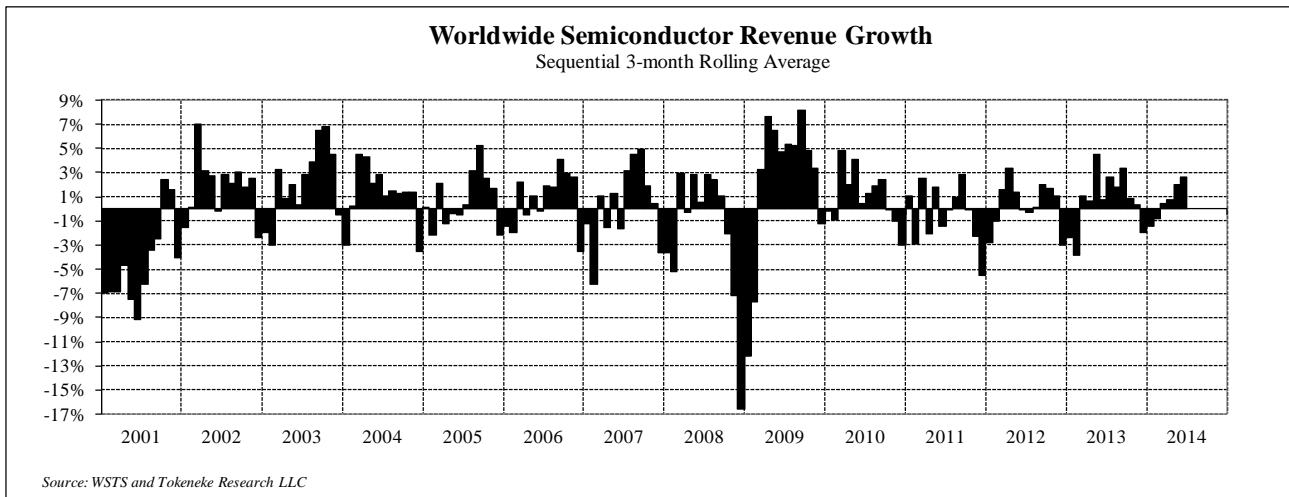
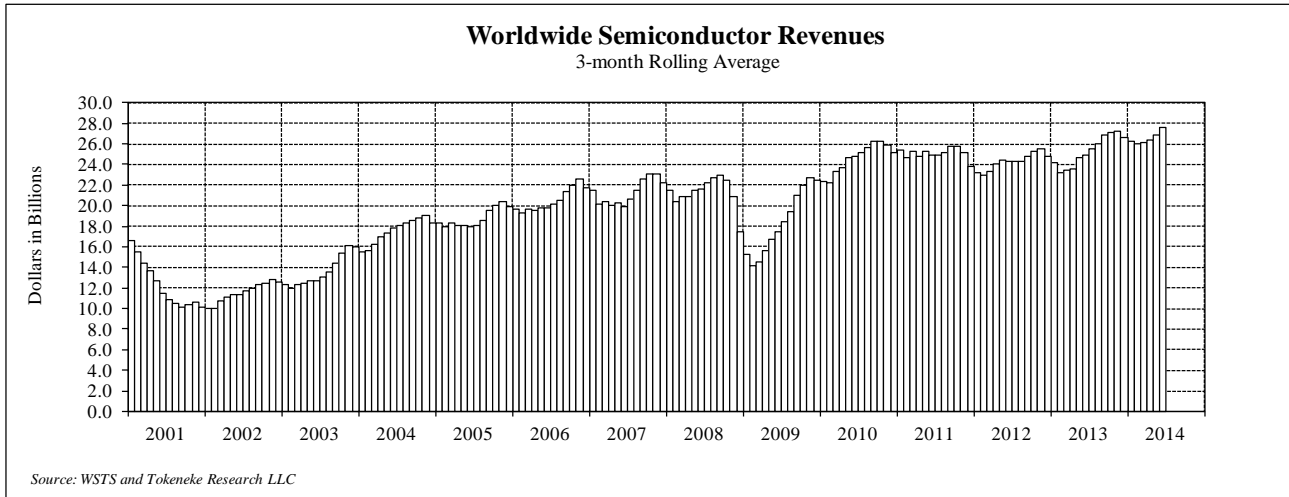
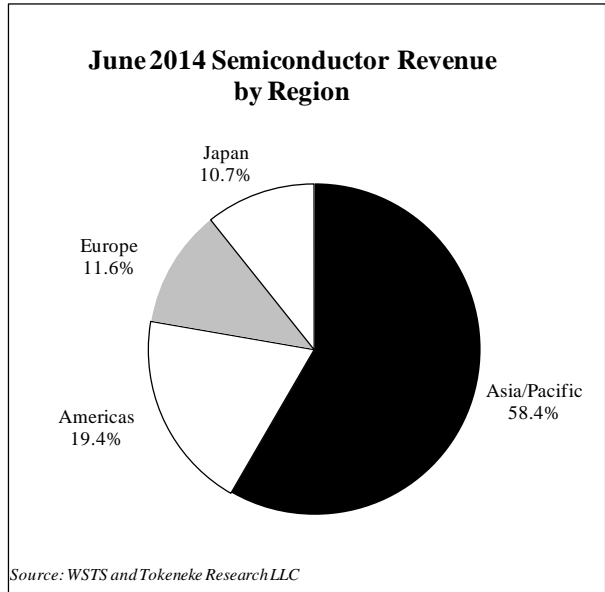
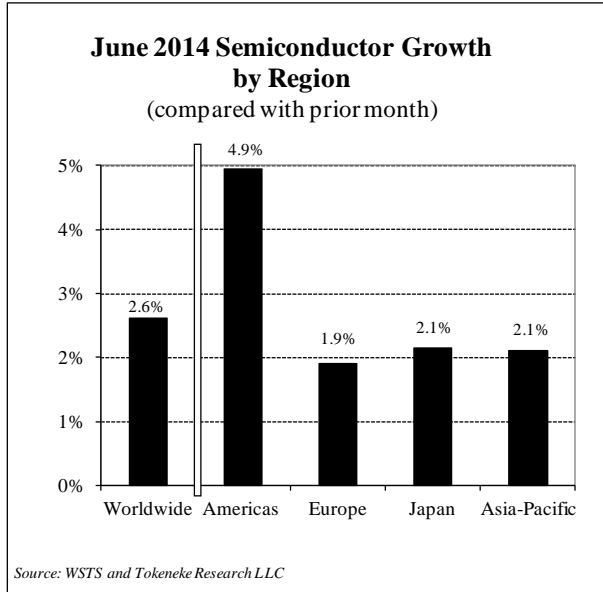
Several years ago semiconductor industry seasonality largely tracked PC market supply characteristics, with a weaker first half of the year including a trough during 2Q, followed by a stronger second half with a 4Q peak. But the world changed after the financial crises in 2008: anemic worldwide macroeconomic conditions have accentuated the relative impact of seasonal business fluctuations; and the rise of the smartphone—and triumph over the PC in terms of total chip sales—has shifted industry seasonality to be more consistent with the traditional consumer market pattern of a 1Q trough, 2Q recovery, 3Q peak and then 4Q decline. While this is very much a gross over-simplification of a \$300B+ industry with many moving parts across a variety of products, geographies and markets, I also don't consider it necessarily inaccurate.

The general pattern of 'consumer market' seasonality has largely played out across the semiconductor industry over the last couple of years, and given persistently lackluster macroeconomic conditions I don't foresee much of a change to that pattern this year. In fact, disappointing and below-average guidance for 3Q appears to confirm it. The specific culprits this year are maturing tablet sales and violent smartphone market share shifts despite healthy automotive and industrial markets and marginal improvements to PCs.

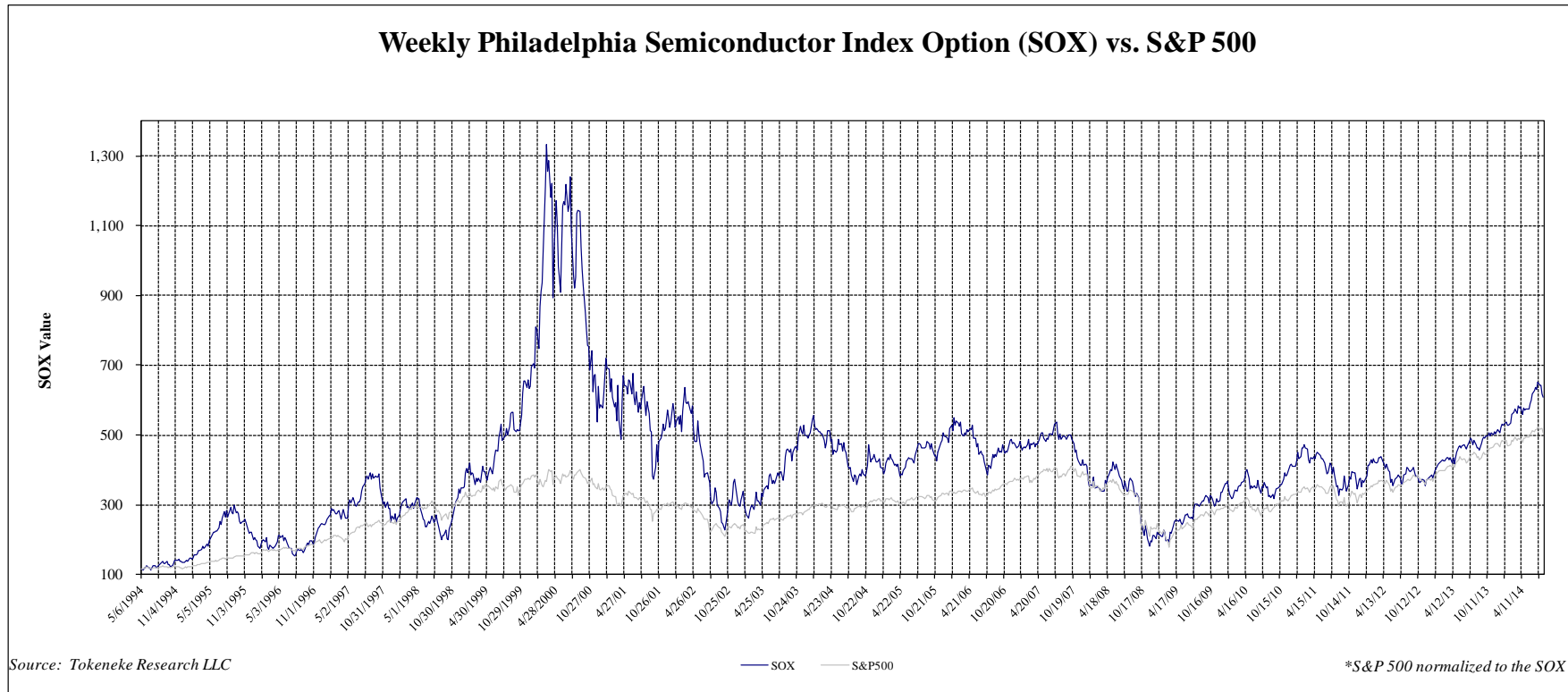
Equity Market Fundamentals: I am also sticking with my previous equity market characterization of persistent volatility. Most financial market prognosticators originally predicted 2014 to be a year of modest gains after last year's oversized rally. While those forecasts may prove prescience by the time it draws to a close, I think the year will more accurately be characterized as a whirlwind of frustration for investors given the volatility we have already experienced during the first half. Somehow I can't see the boredom of predictable stability any time soon.

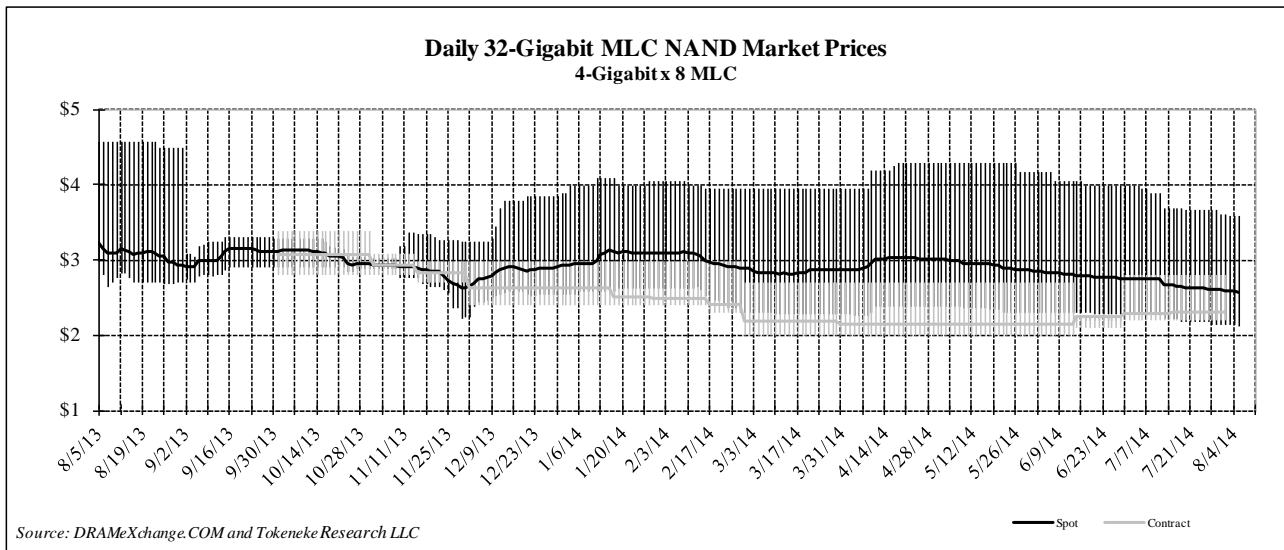
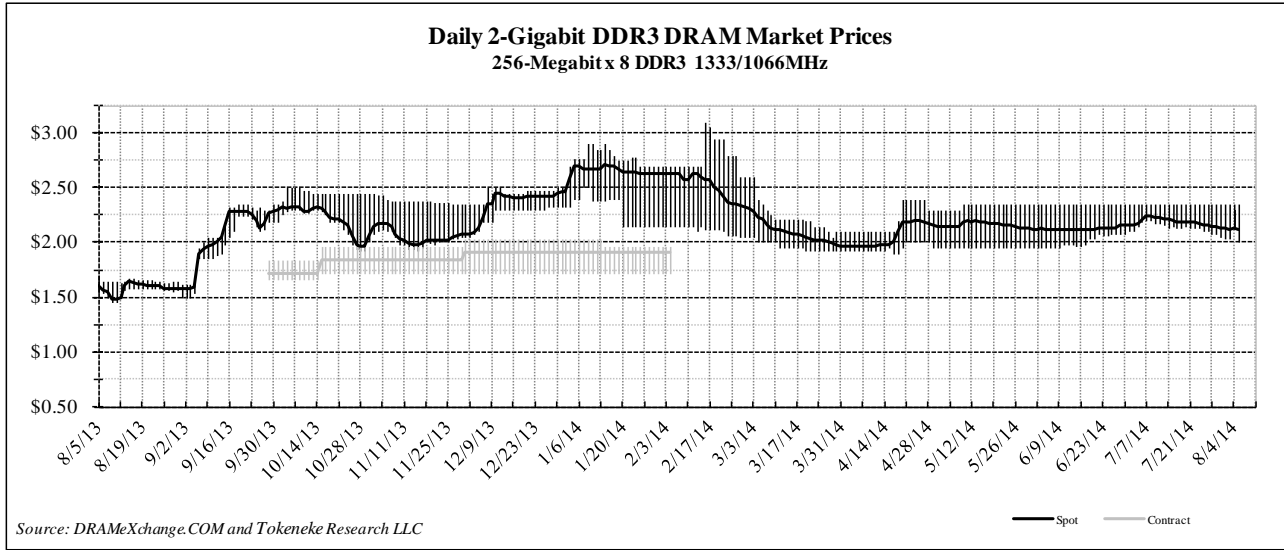
The good news is that equity markets largely appear to be moving consistent with industry fundamentals over the last few months, in my opinion. Chip sector shares rallied amid 2Q business strength after a weak 1Q, and now we are seeing a correction consistent with a disappointing outlook to optimistic expectations for a stronger second half. As a fundamental analyst I am encouraged by such trends and am keeping an eye out for emerging investment opportunities. Stay tuned.

—Dan K. Scovel
Semiconductor Analyst

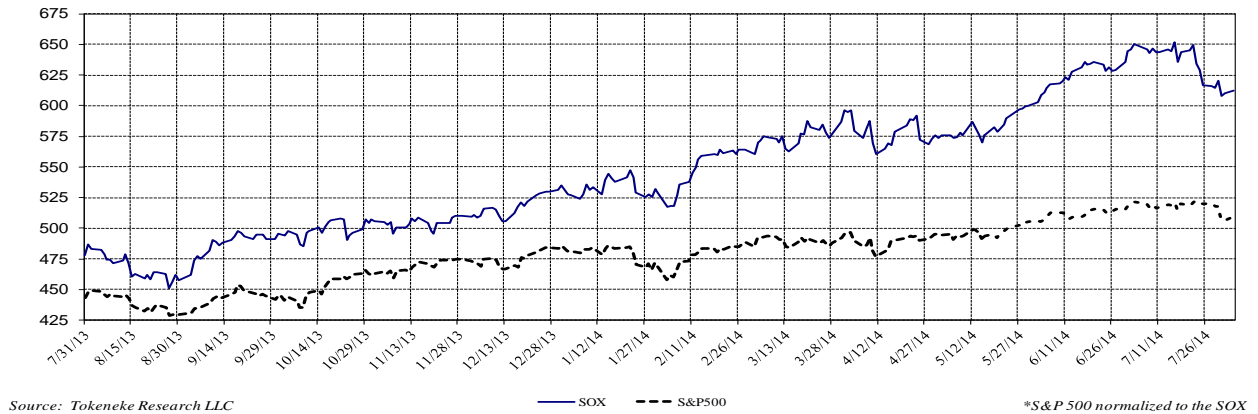


Weekly Philadelphia Semiconductor Index Option (SOX) vs. S&P 500





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



The Company

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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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