Semiconductor Sector Corrects Ahead of 3Q Earnings

3Q Announcements Unlikely to Inspire, But Hope is on the Horizon

The bad news is that semiconductor business conditions have achieved a seasonal peak; share prices are undergoing a correction; and the forthcoming 3Q earnings season is unlikely to offer investors any inspiration, in my opinion. Nevertheless, there are a couple of meaningful silver linings: Near term share price corrections are likely to open up a number of opportunities with attractive potential upside that could easily be realized over the next few months; and longer term the era characterized as the Internet of Things promises unit volume opportunity at least an order of magnitude greater than that for cell phones. In the mean time be patient, and wait for valuations to come to you.

August Underperforms: Worldwide semiconductor industry revenue grew by a lackluster +1.3% sequentially on a three-month rolling average basis during August, according to statistics released by the Semiconductor Industry Association (SIA) late last week. This is the first below-average month since April; was not as strong as I had expected; and compares to an average gain of +1.8% with a high of +5.2%, a low of -3.5%, and declines only four times in the last 24 years—including none of the last 12. The Americas lead once again with growth of +2.3% followed Asia-Pacific with growth of +1.7%. Japan was flat and Europe declined by -1.3%.

Next month's release of September data usually reflects stronger growth: it has averaged a gain of +3.1% with a high of +8.2%, a low of -2.5%, and only one decline in the last 24 years—including none of the last 12. I expect to see flat-ish, below-average growth based on early anecdotal evidence.

3Q Underperformance, as Well: 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 have fallen short of investor's expectations for a more robust second half. The specific weighted average guidance for revenue is currently centered at +5.0% ranging from +2.1% to +7.9% after a handful of preannouncements, up slightly from original guidance of +4.9% ranging from +2.0% to +7.8%. 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.

The handful of preannouncements as of this writing have been mostly negative, although the center point of expected growth edged up with ONNN including the expected contribution from its acquisition of Aptina. Four companies have lowered expectations to declines from flat to modest gains including ENTR, EZCH, ISSI and MXL; two narrowed their range of expected gains including DIOD and MediaTek; and only one, SIMO, raised its expectations for seasonal, double-digit sequential growth.

My fear is that the 3Q earnings season that begins next week Tuesday with INTC will largely disappoint investors consistent with month-to-date weakness in share prices across broader equity markets—and even more so within the semiconductor sector. Why? Three reasons: 3Q expectations for growth started below-average; preannouncements have skewed negative; and the 4Q outlook is unlikely to inspire investors, in my opinion—it has historically been a slow-grower at +1.5%, but has turned negative during seven of the most recent 10 years.

Chip Stocks Correct: Semiconductor sector stocks faded during September, although continue to outperform broader equity markets year-to-date. The Philadelphia Semiconductor Index Option (SOX) declined by -1.0% last month while the average stock in the Tokeneke Universe fell by an even worse -2.3% with only 23 out of 91 issues advancing. These metrics straddled broader equity market decreases from the NASDAQ, S&P500 and DOW of -1.9%, -1.6%, and -0.3%, respectively. Nevertheless, the chip sector continues to outperform by a wide margin so far this year with the SOX up by +19.3% and 56 out of 91 Tokeneke stocks up by an average of +16.4% compared to those same three indices at +7.6%, +6.7% and +2.8%, respectively, as of the end of September.

September

Winners *(23/91)*		**Losers**	
VIMC	163.0%	MXL	-25.8%
AMBA	27.5%	MOSY	-24.8%
NPTN	25.0%	INVN	-23.7%
HIMX	22.0%	AMD	-18.2%
SMI	10.7%	AMCC	-17.4%
average stock -2.3%		*SOX -1.0%*	

3Q

Winners *(33/91)*		**Losers**	
VIMC	269.5%	QUIK	-42.2%
PSMI	80.3%	ADNC	-38.1%
HIMX	48.0%	AMCC	-35.2%
IRF	40.6%	MXL	-31.7%
AMBA	40.1%	MOSY	-22.9%
average stock +1.1%		*SOX +0.4%*	

YTD

Winners *(56/91)*		**Losers**	
VIMC	412.4%	IKAN	-70.6%
TQNT	128.7%	ANAD	-63.4%
RFMD	123.6%	MOSY	-56.2%
SWKS	103.3%	NPTN	-52.5%
SIMO	90.4%	AMCC	-47.6%
average stock +16.4%		*SOX +19.3%*	

Indices

	Sept	***3Q***	***YTD***
SOX	-1.0%	0.4%	19.3%
SMH	-1.1%	3.3%	20.4%
NASDAQ	-1.9%	1.9%	7.6%
S&P500	-1.6%	0.6%	6.7%
DOW	-0.3%	1.3%	2.8%

2014 Depressingly 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 better-than-expected PC unit sales.

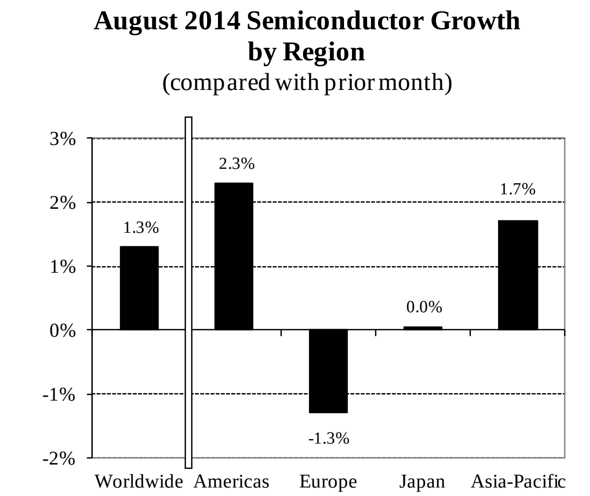
Hope on the Horizon: The bear case against semiconductors claims a maturing industry of slower growth amid supplier consolidation is transferring its profits to shareholders in the form of dividends and share repurchases rather than to fuel growth. But I think the emerging era characterized as the Internet of Things offers the industry a solid platform for robust cyclical growth: mid-single digit annual growth is still triple that of GDP; mergers and acquisitions are pre-positioning assets for the next upturn; and adding growth to the mix of shareholder returns can only enhance valuation multiples. And an eventual macroeconomic recovery will make it even better.

The Internet of Things—personally, I prefer the moniker Smart Things—will differ from PCs and mobile phones in that it will NOT be characterized by a concentration of suppliers and end-markets, but rather a wide variety of highly diverse end-market applications and a fragmentation of both suppliers and technologies offering a plethora of customized solutions carefully optimized for cost, performance and power. Smart door stops, lawn sprinklers and light bulbs will have vastly different system requirements than those for smart automobiles, robots and satellites, to emphasize opposite ends of the scale of complexity. But the best news is that the annual unit volume opportunity will ultimately be orders of magnitude greater than the one billion mobile phones shipping today.

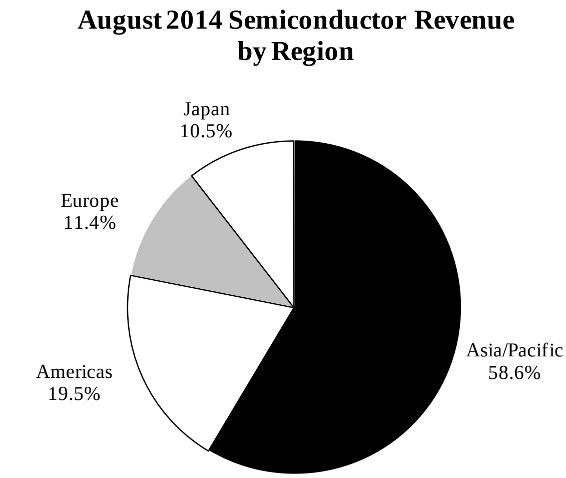
Wait for the Dust to Settle: My bearish call last month isn't looking so bad right now, so I am going to stick with my chip sector caution until the dust settles on the likely uninspiring 3Q earnings season. The bad news is that I don't see much good news from a fundamental business perspective until seasonality turns favorable next spring with 2Q15. However, the share price correction currently underway may well open up a number of attractive opportunities in the near-term with potential upside that could easily be realized by the middle of next year.

Nevertheless, there are always opportunities and exceptions—please see my latest Semiconductor Investment Ideas publication for specifics. In the meantime, sit tight and keep your powder dry: And wait for those opportunities to come to you.

—Dan K. Scovel
Semiconductor Analyst



Source: WSTS and Tokeneke Research LLC



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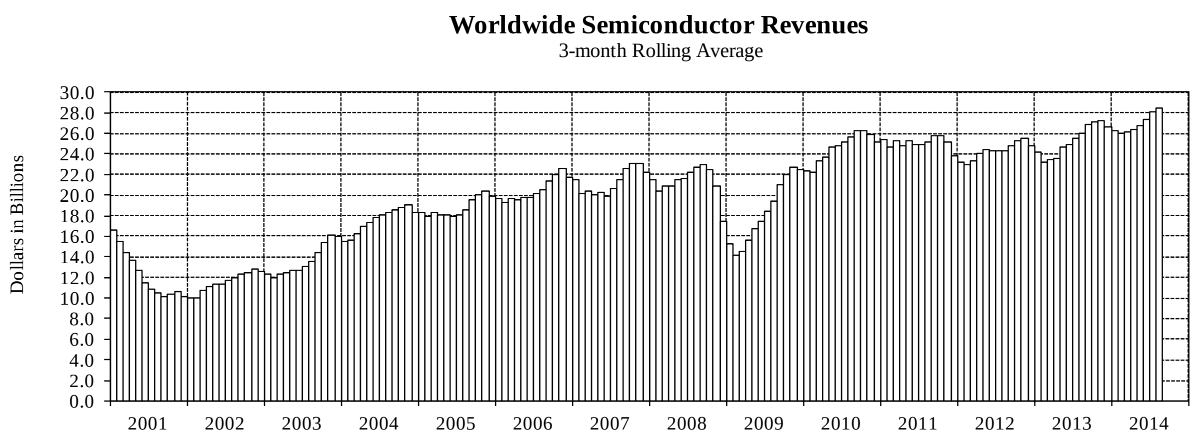

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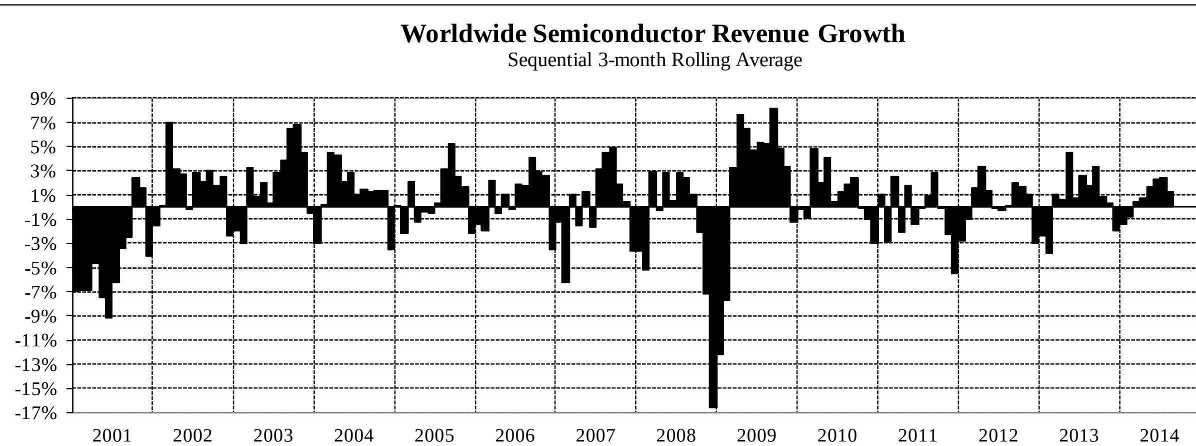

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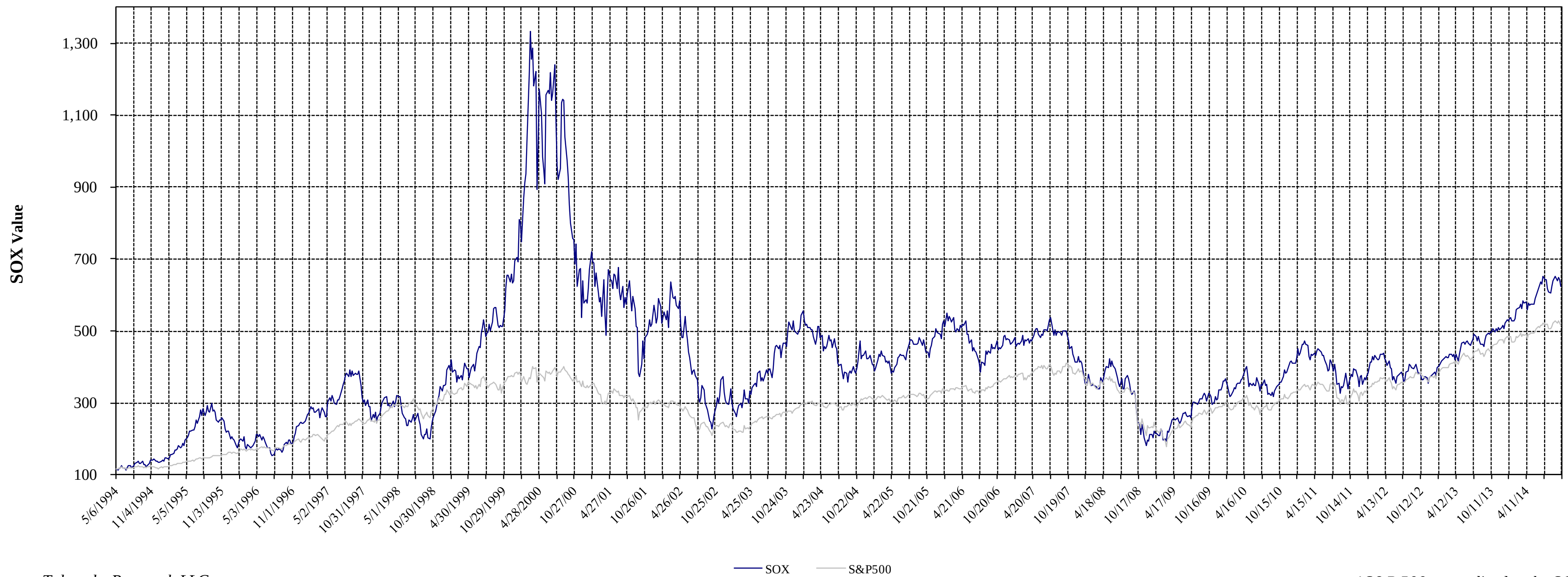
Weekly Philadelphia Semiconductor Index Option (SOX) vs. S&P 500



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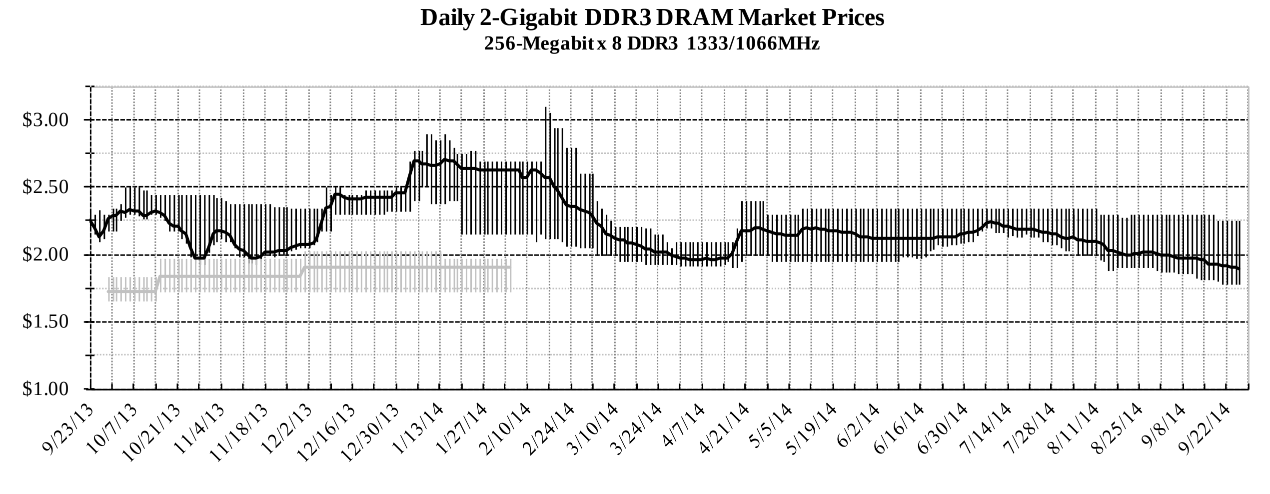
**S&P 500 normalized to the SOX*



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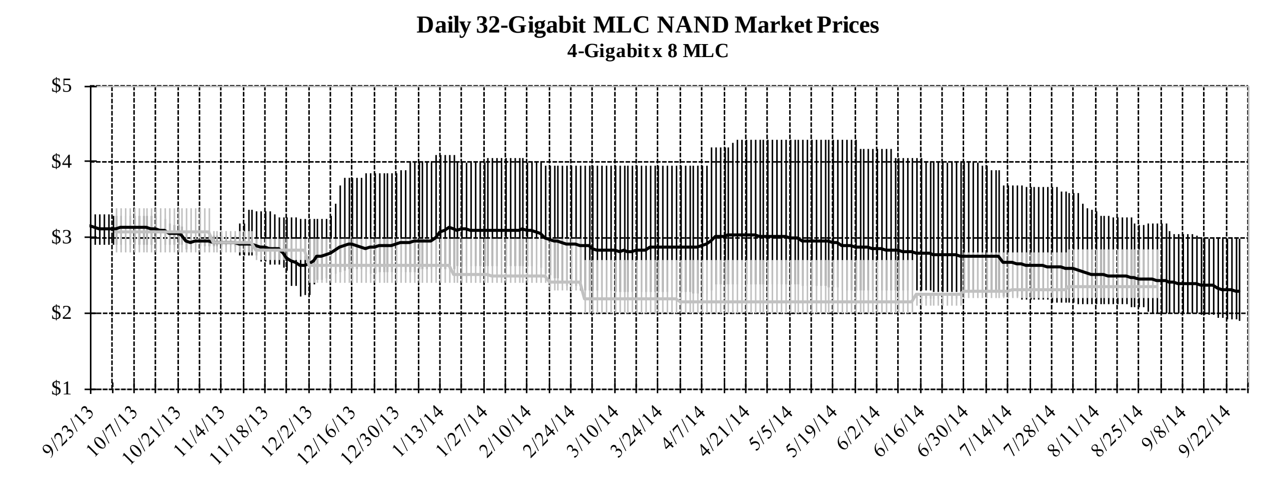

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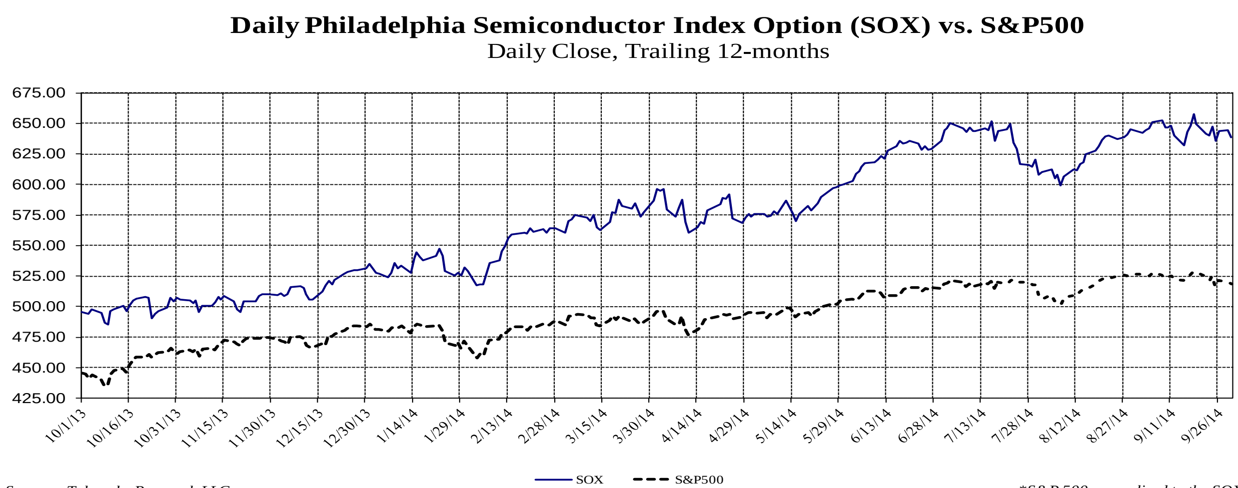

Source: Tokeneke Research LLC

**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.

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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 Fahnestock & 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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