Mixed Bag for January Earnings Season

Business is Murky, but Chip Sector Well Positioned to Lead Equities

The bad news is that the semiconductor industry has recently entered a counter-seasonal cyclical slowdown of unknown depth and duration, although I expect a shallow depth for the couple of quarters. The good news is that the sector appears to be leading an asset allocation rotation back into equities following QE2, U.S. elections and tax relief extensions. The frustration is that we may see a tug-of-war of fits and starts in share price movement between fundamental uncertainty and favorable asset allocation over the next several weeks.

November Decline: November was a weak month for the semiconductor industry, as expected. Chip industry statistics released last week reported a world-wide sales decline of -0.9% on a three-month rolling average basis, which is only the third time in the last 21 years that November has contracted. November is usually a pretty decent month with average growth over the last 20 years of +2.1%, a high of +6.3%, and a low of -7.2%. Nevertheless, it is typically weaker than October and I am not surprised by the incremental decline subsequent to the previously anemic report for October. Europe was the only region that expanded with growth of +2.5% followed by Japan that shrunk by -0.9%, Asia-Pacific by -1.4%, and the Americas by -1.6%.

Forecasting December weakness to be reported next month is an easy call—it always sucks, even when business is good. December has declined on average by -2.5% with a high of +3.3% and a low of -16.6% over the last 20 years, and only two of those twenty have been positive. I would not be surprised to see a reported number 100-200 basis points below average.

Anemic 4Q Earnings Season: The 4Q earnings season begins with Intel reporting later this week and it is highly unlikely to inspire investors: management guidance going into the period was tepid; 14 preannouncements since then haven't helped; and the three off-season early-birds already reporting have missed their numbers. About the best we can hope for is that investors feel relieved that 4Q reports won't be as bad as the bears anticipate.

The original weighted industry revenue growth guidance for 4Q provided with 3Q earnings from over 100 companies in the Tokeneke Universe centered on growth of +1.0% with a range from -1.5% to +3.5%. Unfortunately, this does not compare favorably with the average industry growth over the last 20 years of +2.4%, a high of 16.0%, a low of -24.2%, and declining sales in six of those years.

In addition, the needle hasn't moved much after 14 company preannouncements including two increases, six reiterations, and six declines. RMBS raised its guidance significantly accounting for catch-up royalties and BRCM expects revenue at the high-end of its original range, while six companies either reiterated previous guidance or narrowed their respective ranges, including ALTR, DIOD, LSCC, MCHP, QUIK and TXN. Companies that lowered expectations included ISSI, MSPD, PXLW, TRID, VLTR and XLNX. About the only way to spin this negative skew of preannouncements in a positive vein is to note that the weighted average of industry revenue expectations actually blipped up by an inconsequential 5 basis points; all the negative preannouncements were originally expecting meaning declines anyway; and other than XLNX and maybe VLTR, the disappointers are marginal players not necessarily associated with broader market segment trends.

Finally, we have already seen three early-bird companies report off-set fiscal quarters that capture September, October and November and preview two-thirds of calendar 1Q—and they all missed their numbers. NSM and SMOD exceeded EPS expectations, but missed both reported and guided revenue expectations, while MU missed both reported revenue and EPS (although typically declines to provide specific revenue guidance).

I continue to think 4Q will play-out much like 3Q did as a triumph of tempered expectations for investors. It's going to be a pretty flat quarter and that will be a relief if you are expecting a dip—but a disappointment if you are expecting anything close to what has been traditional seasonal strength.

Stable 2011: As I noted last month, 2011 is shaping up to be a year of mid-single-digit growth as a result of two strong headwinds: the mathematical curse coming off a year of strength with 2010 up by +33%; and a slow and uncertain beginning to the period given current business conditions.

Tech Leads the Way: The semiconductor sector slightly underperformed relative to broader equity markets during December. Last month the Philadelphia Semiconductor Index Option (SOX) gained +5.6% while the S&P500 and NASDAQ gained +6.5% and +6.2%, respectively, although the DOW grew by only +5.2%. Posting over a 5% gain after November's similar gain in a flat-to-down market environment reflects meaningful strength, in my opinion, supporting my assertion that technology is leading an equity market recovery.

Broader macroeconomic issues have been driving share prices rather than industry fundamentals for several months now, in my opinion, and they continue to do so. In fact, business fundamentals certainly have NOT been the source of recent share price strength across the chip sector. I continue to believe the sector is at the front-end of a financial market rotation away from fixed income, commodities and foreign exchange and back into equities following QE2, the November elections in the US, and the recent tax-credit extensions.

December

Winners *(87/103)*		**Losers**	
NXPI	66.4%	CEVA	-11.6%
MOSY	39.5%	RMTR	-7.7%
LSCC	36.2%	QLGC	-4.9%
ENTR	35.1%	SIMG	-4.2%
ZRAN	27.9%	MRVL	-3.8%
average stock	*+8.8%*	*SOX +5.6%*	

4Q

Winners *(86/103)*		**Losers**	
NXPI	68.9%	SIMO	-22.0%
IPHI	67.4%	MSPD	-21.5%
FCS	66.1%	TXCC	-17.1%
DIOD	57.9%	NLST	-14.1%
MIPS	55.7%	INFN	-11.5%
average stock	*+19.7%*	*SOX +17.9%*	

2010

Winners *(73/103)*		**Losers**	
ENTR	293.5%	NLST	-50.7%
MIPS	247.1%	SPWR	-45.8%
SPRD	236.4%	MPWR	-31.1%
QUIK	203.3%	CNXT	-29.7%
SIMG	184.9%	AOSL	-28.7%
average stock	*+34.6%*	*SOX +14.4%*	

Indices

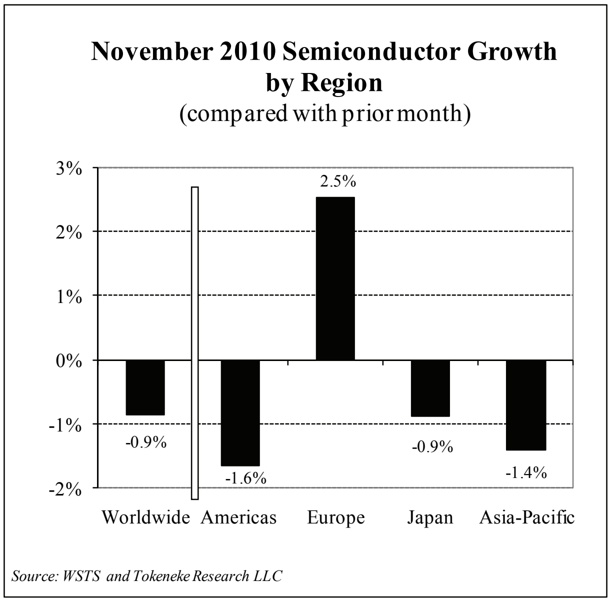
	Dec	***4Q***	***2010***
SOX	5.6%	17.9%	14.4%
SMH	4.7%	17.4%	16.5%
NAS	6.2%	12.0%	16.9%
S&P500	6.5%	10.2%	12.8%
DOW	5.2%	7.3%	11.0%

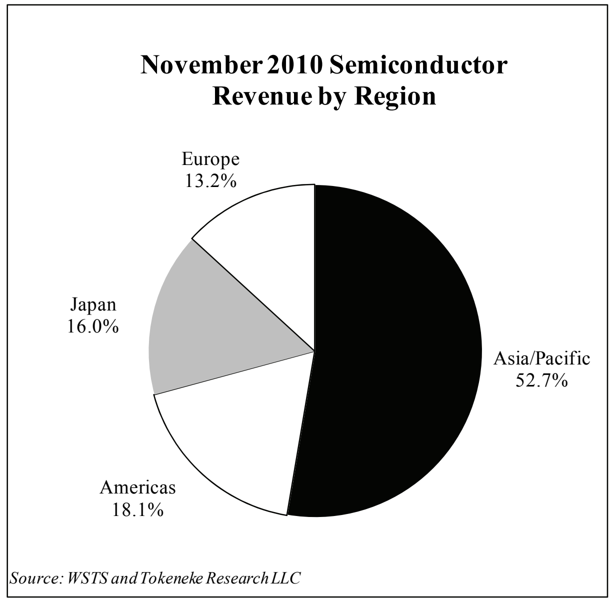
Opportunity to Buy and Trade: I continue to believe that the depth of the current slowdown in the industry will be fairly shallow due to extremely tight channel sensitivity to inventory, and will feel more like a plateau than a dip before any meaningful uptick occurs with 2H11 seasonal strength. Nevertheless, the truth is that company order visibility is very opaque and neither the depth nor the duration of current weakness is foreseeable at the current time.

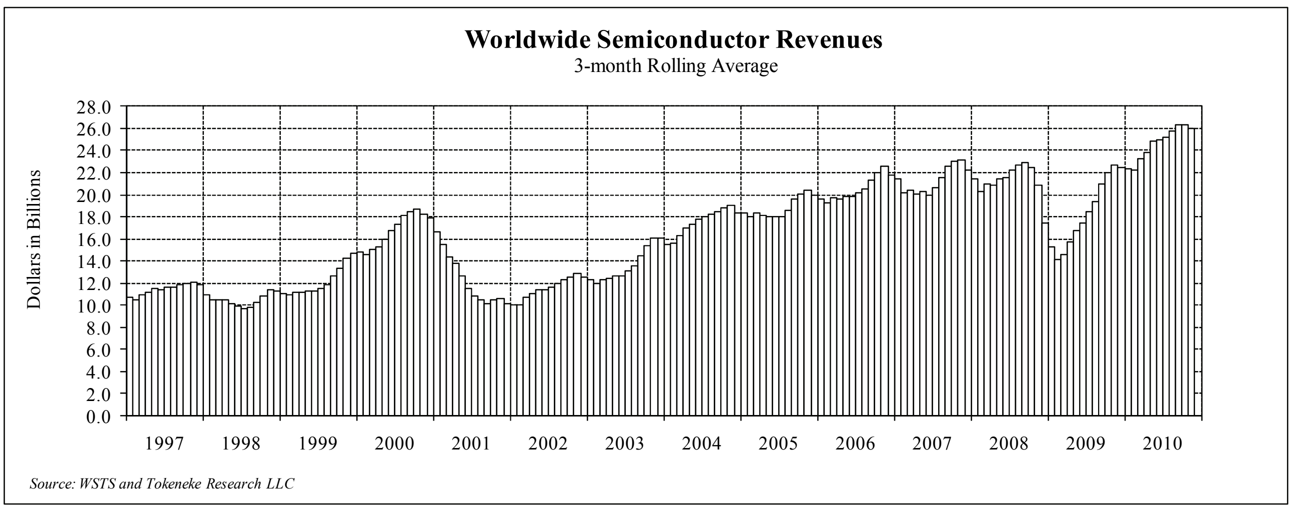
For investors with longer time horizons, say 2 years or so, chip sector equities remain extremely attractive at current valuation levels. Unfortunately, near-term business uncertainty does not bode well for the faint of heart or those investors with shorter time horizons over the next few months. Nevertheless, recently renewed investor enthusiasm for equity vehicles appear to have trumped such fundamental concerns, setting up a situation favorable for both longer-term investors and short-term traders if we experience a period of fits and starts triggered by fundamentals and equity allocations, respectively, as I believe we might.

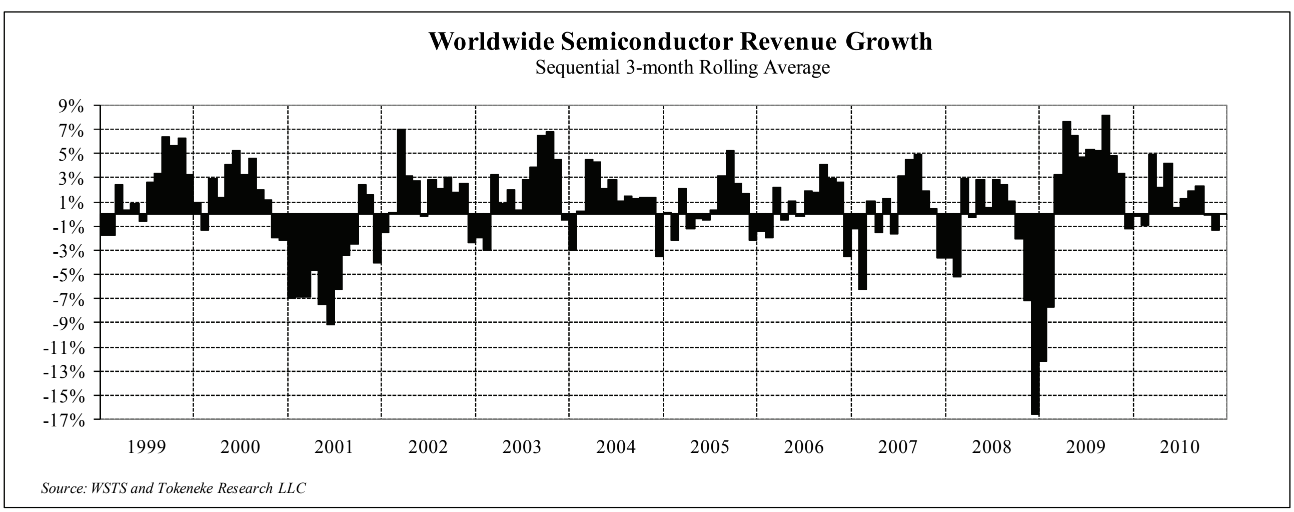
It's a good time to buy, and may well prove to be a good time to trade. But it may also prove to be a frustrating time to hold. Opportunities exist—at least for investors with longer term time horizons and greater-than-normal appetites for risk and volatility.

—Dan K. Scovel
Semiconductor Analyst


November 2010 Semiconductor Growth by Region
(compared with prior month)
3%
2%
1%
0%
-1%
-2%
-0.9%
-1.6%
2.5%
-0.9%
-1.4%
Worldwide
Americas
Europe
Japan
Asia-Pacific
Source: WSTS and Tokeneke Research LLC


November 2010 Semiconductor Revenue by Region
Europe 13.2%
Japan 16.0%
Asia/Pacific 52.7%
Americas 18.1%
Source: WSTS and Tokeneke Research LLC


Worldwide Semiconductor Revenues
3-month Rolling Average
Dollars in Billions
28.0
26.0
24.0
22.0
20.0
18.0
16.0
14.0
12.0
10.0
8.0
6.0
4.0
2.0
0.0
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
Source: WSTS and Tokeneke Research LLC


Worldwide Semiconductor Revenue Growth
Sequential 3-month Rolling Average
9%
7%
5%
3%
1%
-1%
-3%
-5%
-7%
-9%
-11%
-13%
-15%
-17%
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
Source: WSTS and Tokeneke Research LLC

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

Sources: 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 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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