

Chip Business Stabilizes, But Valuations Stretched

Q2 Earnings Robust, But Not Enough End-Demand Follow-Through To Sustain It

Summary: I think recent business gains across the semiconductor sector are primarily channel inventory replenishment exercises that are unlikely to persist due to an elusive recovery in end-market demand. Because of this, I believe the sector is at risk of correcting over the next few weeks—especially after last weeks rally triggered by surprisingly strong earnings from INTC.

Statistical Advancement: Semiconductor industry statistics for May were released earlier this month and worldwide sales advanced by 5.4% sequentially on a three-month rolling average basis, slightly down from the prior month's 6.4%. This is record growth compared to the historical May average of +0.9% since 1990 with a previous high of +4.1%, a low of -7.5%, and only five contracting years out of the last 19. It is also the third month of gains after five months of free fall that began last October. Japan spike up nicely at 7.2% followed by Asia-Pacific at 6.7% and the Americas at 3.9%. Europe lagged once again with a gain (instead of a decline, this month) of 0.4%.

Historical statistics continue to offer negligible perspective after 40% of industry sales vaporized between October and March. I expect June's numbers to be released in early-August will also reflect significant gains. For what it's worth, June has traditionally been pretty flat with an average gain of +0.3%, a high of +5.3%, and a low of -9.2% with nine negative growth periods in the last 19 years.

2Q Earnings Preview: I am expecting reported revenue and earnings for 2Q to exceed expectations across the board due to conservative guidance by management. Revenue guidance was conservative at the beginning of the period based on backlog and turns orders at the time; and earnings are likely to be secured via similar conservatism amid accelerated restructuring activities.

Weighted average revenue growth based on the extended Tokeneke Universe of over 100 companies called for industry sales to grow by 8.4% based on original 2Q guidance offered during 1Q earnings, with a range of +5.5% to +11.4%. After 20 preannouncements that number has shifted up to +10.5% with a range of +8.3% to +12.8%. Only five of those preannouncements lowered expectations (ACTL, QUIK, RMBS, SIMO and XLNX), while 15 raised expectations (CHRT, DIOD, ISIL, LSCC, MSCC, MRVL, MSPD, OIIM, QCOM, SLAB, SMI, SMSC, STEC, TRID and TXN). I would not be surprised to see actual sequential industry growth slightly greater than the high-end around +13%, which would rival the best 2Q the industry has experienced since +15.2% in 1995.

As of this writing, nine companies have already reported 2Q and all have exceeded earnings expectations, although only six have exceed expectations for revenue: XLNX met preannounced weakness due to product constraints, and MU and SMOD missed their May-ending periods on adverse DRAM product mix.

The big issue in 2Q earnings season will be 3Q guidance, in my opinion—and order visibility remains limited.

Intel Raises the Bar: The 2Q09 earnings season started with a bang last week as Intel's surprisingly strong 2Q announcement—and especially 3Q guidance—drove sector prices higher. My fear is that Intel's strength has set expectations to an unreasonably high level for the rest of the sector to achieve over the next few weeks—and certainly unlikely to exceed. I was bearish coming into the month based on stretched valuations amid 3Q uncertainty. The good news is that early indications for 3Q are better than I feared they might be. The bad news is that I don't think they will be anywhere near as good across the sector as Intel has indicated. The worse news is that investors appear to have already baked-in expectations for typically strong 4Q seasonality.

Sector Stalls: The Philadelphia Semiconductor Index option (SOX) eased by 3.0% during June, but declined by 7.9% from June 1 (instead of May 31) to the end of the month. Nevertheless, it has rallied by 10% so far in July following INTC's robust earnings last week. The tables below indicate winners and losers so far this year through the end of June. While a number of equities are registering significant triple-digit gains and double-digit losses, one needs to beware of the curse of small numbers: of the 112 stocks in the Tokeneke Universe, 9 were trading for under \$1.00, 20 were under \$2.00, and 48 were trading under \$5.00 per share as of the end of June. Penny stocks can make for big percentage movers.

June			2Q			YTD			Indices		
Winners (7/0/112)	Losers		Winners (7/05/112)	Losers		Winners (7/08/112)	Losers		Jun	2Q	YTD
SPRD 57.2%	MTLK -24.0%		PXPL 380.0%	QUIK -20.2%		STEC 444.4%	SIMG -45.5%		SOX -3.0%	14.0%	24.0%
STEC 41.5%	MIPS -22.9%		STEC 215.1%	VTSS -12.5%		RFMD 382.1%	RMTR -38.0%		SMH 1.7%	14.7%	21.8%
TXCC 40.0%	SMOD -18.1%		ENTR 204.1%	MOSY -9.3%		ENTR 350.0%	LOGC -34.8%		NAS 3.4%	20.0%	16.4%
TSEM 35.7%	UMC -17.5%		RFMD 182.7%	ALTR -7.2%		MTLK 280.0%	SPWR -28.1%		S&P500 0.0%	15.2%	1.8%
TWLL 32.0%	AMD -14.8%		PXLV 166.1%	LOGC -6.2%		SPRD 185.9%	PXPL -22.6%		DOW -0.6%	11.0%	-3.8%
average stock +5.3%	SOX -3.0%		average stock +43.5%	SOX +14.0%		average stock +57.3%	SOX +24.0%				

Islands of Strength: I continue to expect chip industry sales to decline by -20% to -25% this year, with the low-end of the range more likely if business stalls out during the second half of the year, and the high-end more likely if we see somewhat of a normal, seasonal 4Q in terms of sequential growth. Nevertheless, islands of strength persist amid this year's weakness: netbooks expected to double (albeit off a low base), LCD TV units to expand by some 20% (although rivaled by system ASP degradation), smart phones to grow by 10% to 20%, Chinese 3G infrastructure expansion, MEMS product growth, and DRAM and NAND market price recovery. The good news is that these areas are experiencing growth; the bad news is that they aren't bigger markets in and of themselves.

A Question of Valuation: Depressed earnings have rendered price-earnings ratios problematic, and balance sheets are under unusual scrutiny for net cash—for once, in this growth-oriented sector where income statements have always ruled. At first glance there should be numerous buying opportunities with prices at historically low levels. In fact, over 80% of the Tokeneke Universe is currently trading below long-term average price-sales ratios on a trailing 12-month basis. Unfortunately, sales are expected to be lower this fiscal year in over 80% of my companies, which renders the trailing 12-month ratio overstated. Valuing equities in a growth sector that happens to be shrinking by 20% is an exercise in multiple compression. In other words, it's a stock-pickers market for short-term traders.

More Risk Than Reward: Long-term, I continue to believe the chip sector will fare better than most when a recovery finally occurs due to rapid retrenching and the notable lack of excess inventory at the onset of this downturn. Near-term, business has stabilized and appears to be improving due to channel inventory restocking, although order lead time visibility remains limited and ultimate end-market consumption remains muted. I would characterize what we have seen so far as pronounced seasonality due to inventory restocking. My fear is that this particular business cycle has been counter-seasonal thus far, and may continue as such into the seasonally stronger second half of the year. I think it is possible that a normal, seasonally strong 4Q will fall flat after a 3Q punctuated by restocking. In the meantime, valuations have become much more nuanced and would be at risk under such a scenario—in my opinion.

I think the sector is due for a correction, and could easily give back half of its gains since early-March. Yes, the recession has subsided and near-term business levels have improved, but virtually all gains have been inventory-related and end-market demand appears to have stabilized with limited visibility and uncertain prospects for foreseeable growth. In other words, the recession is over, but the recovery remains elusive.

The bottom line: I don't trust this economy.

—Dan K. Scovel
Semiconductor Analyst

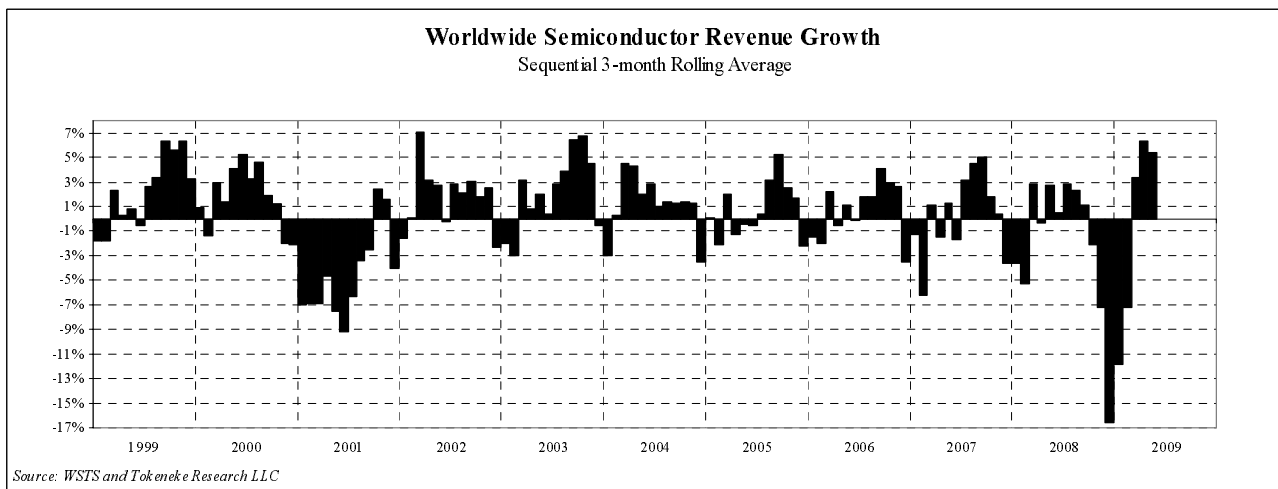
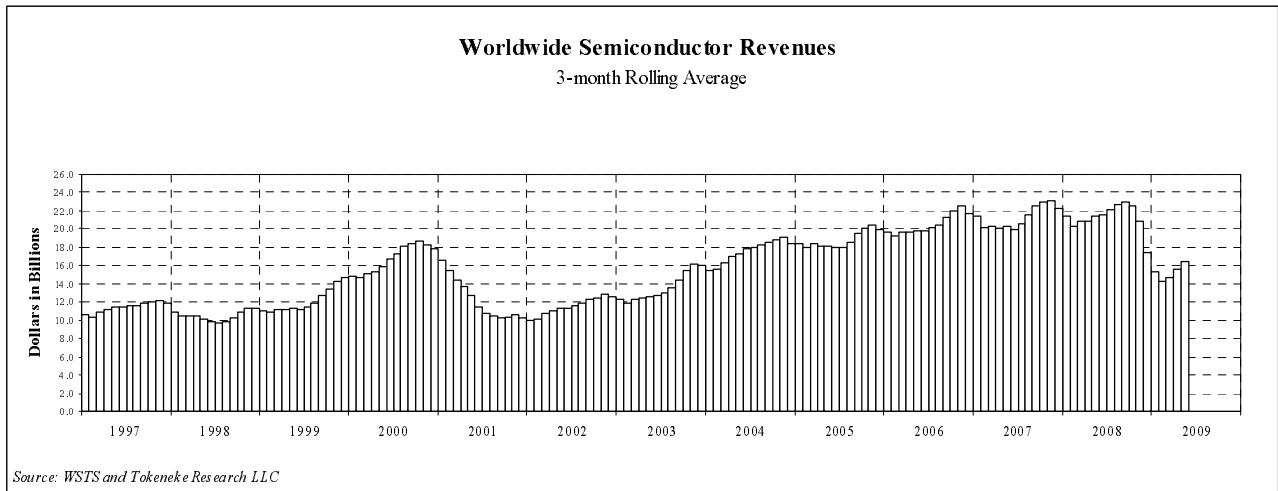
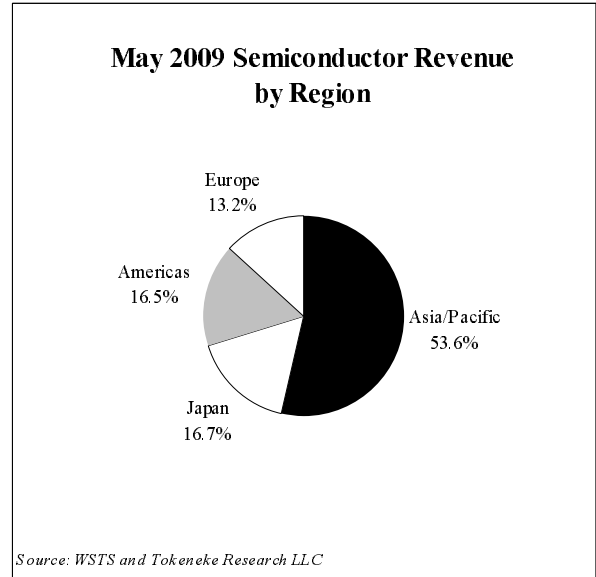
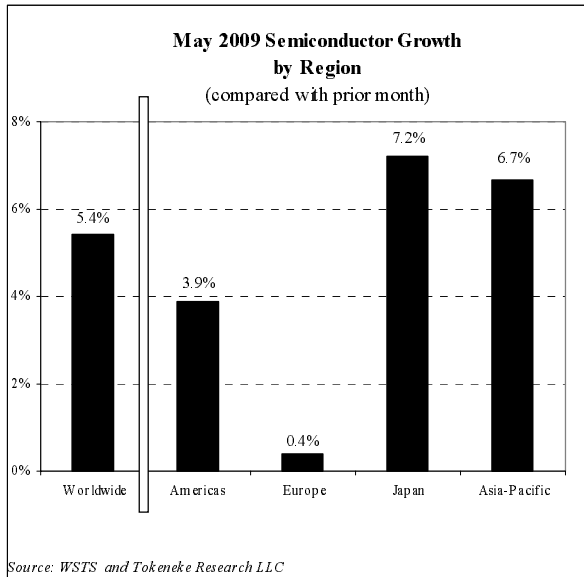
Stock Recommendations: Please see the most recently published reports for additional information.

MU: Buy recommendation with a 12-month target price of \$10—for the unusually risk-tolerant investor.

TXN: Buy with a 12-month target price of \$25. Trade it between technical support around \$14 and \$25.

INTC: Hold. Fully valued at \$21. Trade it between technical support around \$12.50 and \$21.

NSM: Hold. Fully valued at \$15. Trade it between technical support around \$9.50 and \$15.



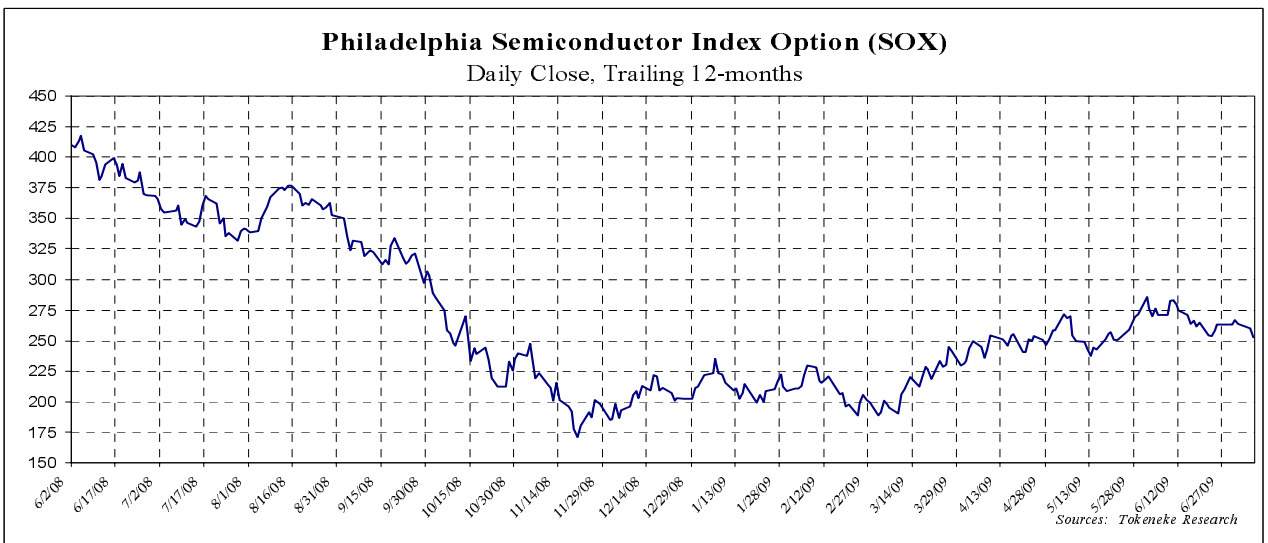
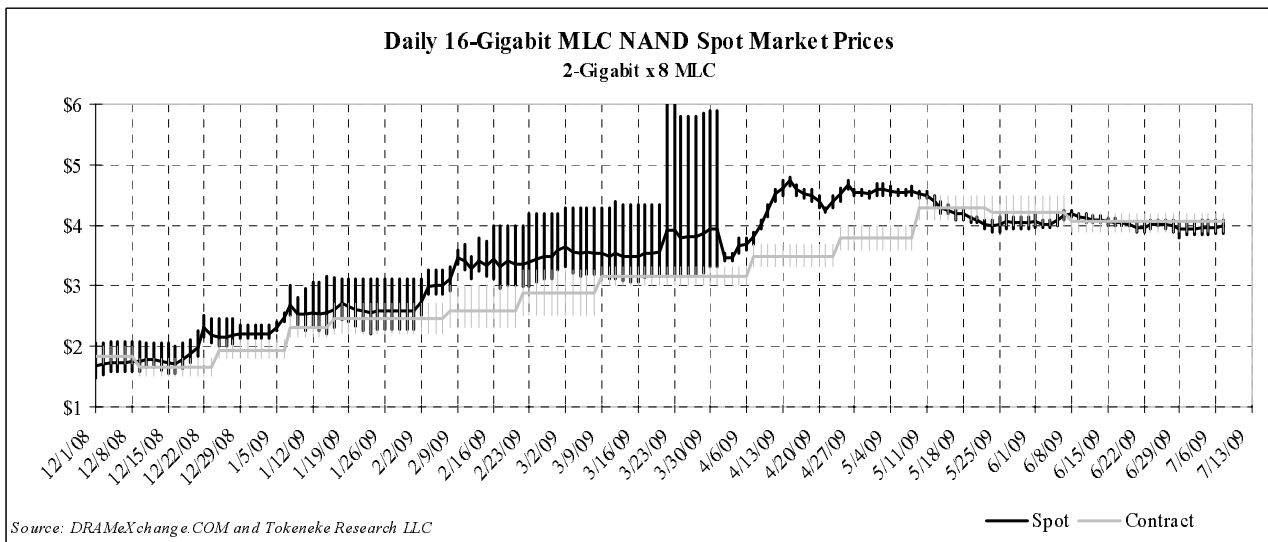
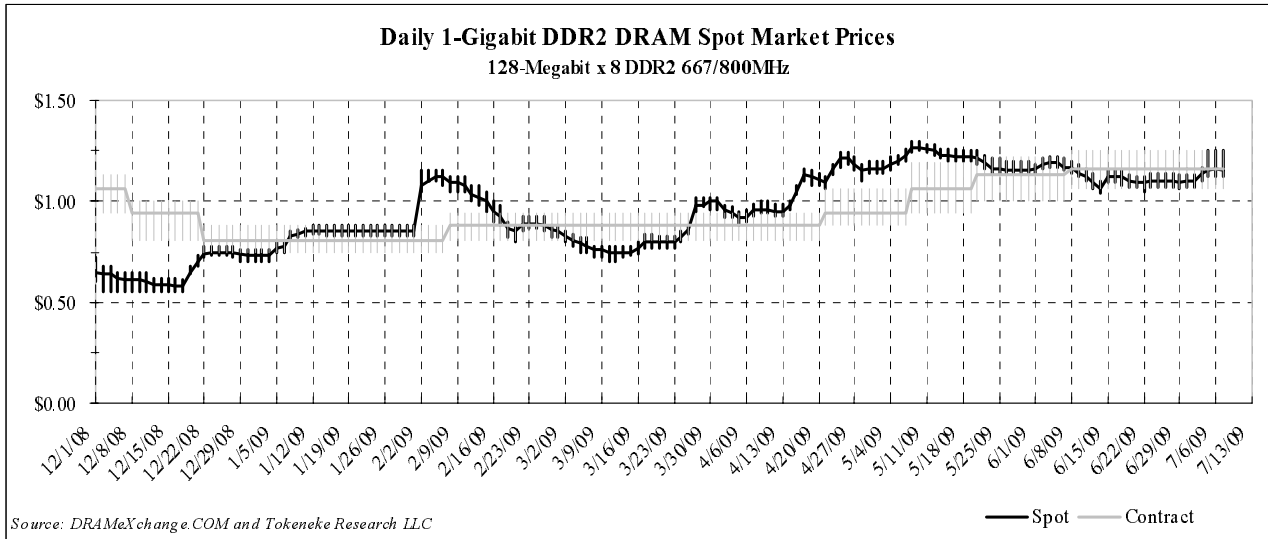
Weekly Philadelphia Semiconductor Index Option (SOX) vs. S&P 500



Sources: Tokeneke Research LLC

— SOX — S&P500

*S&P 500 normalized to the SOX



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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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