Counter-Seasonal Business Cycle Softens

Hopefully More Plateau than Double-Dip

After six quarters of solid growth following the global financial meltdown at the end of 2008, the semiconductor industry is finally softening consistent with the current counter-seasonal business cycle based on deteriorating business conditions and sub-par revenue guidance for 4Q offered by companies during the 3Q earnings season. Nevertheless, valuations across the sector remain very attractive and offer meaningful opportunities—at least for highly courageous investors with time horizons beyond a couple of years.

September Expansion: Semiconductor industry statistics for September were released last week reflecting pretty average sequential monthly revenue growth worldwide, with the rest of the world more than offsetting weakness in the US. Worldwide sales grew by 2.9% over the prior month on a three-month rolling average basis, consistent with the average for this month since 1990 of 3.1%, a high of 8.2%, and a low of -2.5%. Only once in the last 20 years has September declined. All regions grew led by Europe with 3.9%, Japan with 3.7% and Asia-Pacific with 3.2%, while the Americas lagged at 0.5%. For 3Q10 overall, the chip industry expanded by 6.1% over the prior quarter, slightly below the average of 6.7%. Quantitatively, this is a decent performance. Unfortunately, it is viewed as a disappointment after the last six quarters of record and well-above-average growth. The 3Q high since 1990 was 19.9% (just last year!), the low was -11.7%, and the period has only declined twice in the last 20 years.

I expect October statistics released next month to reflect continued expansion, although at lower than an average pace. October has averaged 2.8% with a high of 6.8%, a low of -2.0%, and only one decline in the last 20 years.

3Q Triumph of Tempered Expectations: The 3Q10 earnings season is drawing to a close, and can best be described as a triumph of tempered expectations, in my opinion. The good news is that 3Q has largely exceeded expectations, but the bad news is that 4Q guidance has been weak. The saving grace has been chip sector share prices finally outperforming the equity markets as 3Q reports more consistently bettered tempered expectations than they had in the first two weeks of the reporting season.

Expectations were originally tempered for 3Q by fears that worldwide macroeconomic weakness would finally catch up to the last five quarters of relatively robust industry expansion. Expectations were then more formally reset with the lowering of guidance by no less than nine out of 15 companies. These preannouncements helped results largely come in ahead of those revised expectations: over half of chip companies reported 3Q earnings exceeding expectations compared with about 10% falling short on EPS; and about half reported strong 3Q sales, with less than one-quarter missing their sales number.

In addition, earnings reports got progressively better as the 3Q earnings season has unfolded. On a weighted revenue basis, 3Q industry sales as reflected by the Tokeneke Universe grew by only +3.5% the first week, but then accelerated to +3.9% the second week and then popped up to +5.5% by last week. On an average company basis 3Q sales growth started off at +4.6% the first week and expanded to +5.9% by last week. If we look at the trend based on my grading system (a rating that combines 3Q sales, 3Q revenue and 4Q revenue guidance), the performance to expectations has skewed very positive over the last couple of weeks with only 25% of reporting companies meeting or exceeding cumulative expectations the first week, falling to 22.7% the second week, but popping up nicely to a total of 35.9% last week. (See the 3Q Earnings Summary publication for all the gory details.)

4Q Weakness: The primary disappointment this earnings season has been 4Q revenue guidance, with just under half of reporting chip companies falling short to expectations compared to one-quarter exceeding them. Even worse, the outlook deteriorated as the reporting season unfolded: weighted industry revenue guidance fell from -1+4% the first week to -2+3% last week, while the average company dropped from -2.5+1.7% to -6-1%. This combined outlook clearly signals a disappointing 4Q that has averaged industry growth of 2.4% with a high of 16.0% and a low of -24.2%, albeit declining sales in six out of the last 20 years.

Both metrics deteriorated and we are clearly looking at a flat to down period, but the spread between the two different measures, weighted vs. company average, can be explained by more positive relative outlooks by nine companies in the billion-dollar revenue club, including ALTR, ATML, BRCM, INTC, LSI, QCOM, SNDK, STM and SWKS. Why is this? Are the rich getting richer, or are they just oblivious? I think they are oblivious. Most companies are being conservative amid limited order visibility, so I don't think the industry will perform as poorly as the average company is guiding on a percentage growth basis. However, at the same time I fear these larger companies as a group may be banking on macro trends of existing backlog and seasonality that could very well prove to be at least somewhat optimistic in the current business environment.

Start-Stop Rally: Chip sector share prices handily out-performed the broader equity markets last month, although continue to underperform on a year-to-date basis. Net-net, the 3Q earnings season has been favorable to the group, albeit in fits and starts and largely tracking with reported performance relative to expectations. During the first week of the earnings season, the sector outperformed: the SOX index advanced +2.0% against the S&P500 growing only +0.9%. This reversed the second week as reported earnings deteriorated with the SOX declining -0.1% and the S&P growing by +0.6%. But as earnings improved, chip sector equities as a group have responded in kind: two weeks ago the SOX outperformed the S&P by +4.4% to +0.0%, and last week (the first week of November) it even bettered the rally following elections and the Fed's QE2 by +5.2% to +3.6%.

October			
Winners *(78/103)*		**Losers**	
MIPS	50.9%	INFN	-29.8%
ACTL	30.8%	CRUS	-27.9%
CEVA	29.4%	TXCC	-16.0%
AUTH	29.1%	ENTR	-12.8%
SIMG	28.7%	ISSI	-12.8%
average stock +7.2%		*SOX +6.7%*	

YTD			
Winners *(60/103)*		**Losers**	
MIPS	236.4%	NLST	-40.1%
QUIK	181.0%	IKAN	-39.0%
ENTR	172.6%	AOSL	-37.7%
SPRD	161.4%	ZRAN	-35.9%
SIMG	138.4%	NVDA	-35.7%
average stock +20.8%		*SOX +3.5%*	

Indices	*Oct*	*YTD*
SOX	6.7%	3.5%
SMH	6.5%	5.7%
NAS	5.9%	10.5%
S&P500	3.7%	6.1%
DOW	3.1%	6.6%

Business Plateau: The current business environment across the semiconductor sector is unsettling to this fundamental analyst for two reasons. First, is because the macroeconomists got it right a few months ago when forecasting weakness as industry players were reporting solid business conditions with accelerating order patterns amid extended lead times, spot product shortages, and lean inventories. My experience has been that macroeconomists more typically tend to lag us fundamentalists as raw data on business conditions trickle-up from ground level to those loftier perspectives. However, this time they got it right—and we got it wrong.

Secondly, is the uncertainty with respect to depth and duration of current softness. My opinion is that the depth will be fairly shallow due to extremely tight channel sensitivity to inventory, and will feel more like a plateau than a dip. It also appears unlikely that any meaningful uptick will occur before 2H11 seasonal strength. Nevertheless, the truth is that company order visibility is very opaque and neither of these attributes is foreseeable at the current time.

Opportunity for the Courageous: For investors with longer time horizons, say 2 years or more, chip sector equities remain extremely attractive at current valuation levels. Unfortunately, near-term business uncertainty and the lack of investor enthusiasm for equities overall do not bode well for the faint of heart for those with shorter time horizons over the next few months. The decision to buy into current weakness is easy; actually doing it requires one heck of a lot of courage.

—Dan K. Scovel
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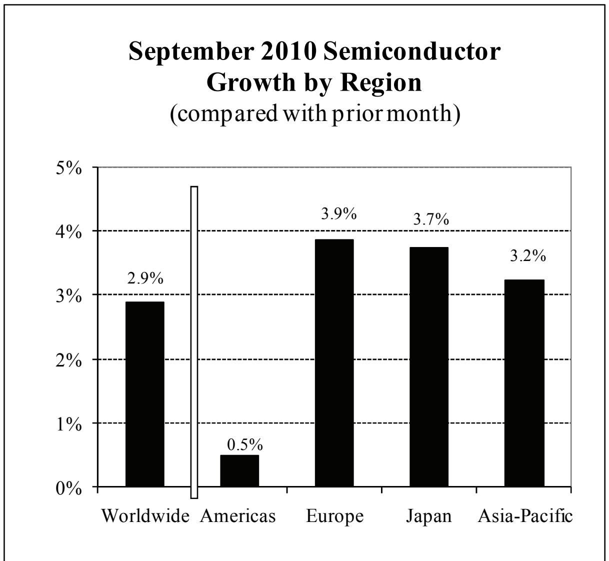
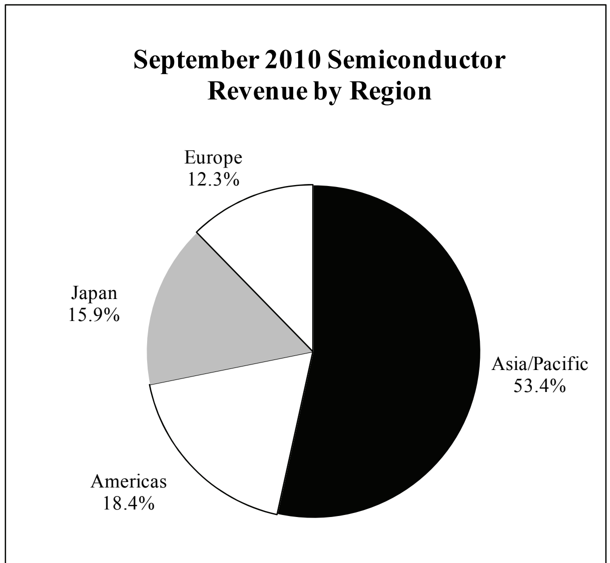


Source: WSTS and Tokeneke Research LLC



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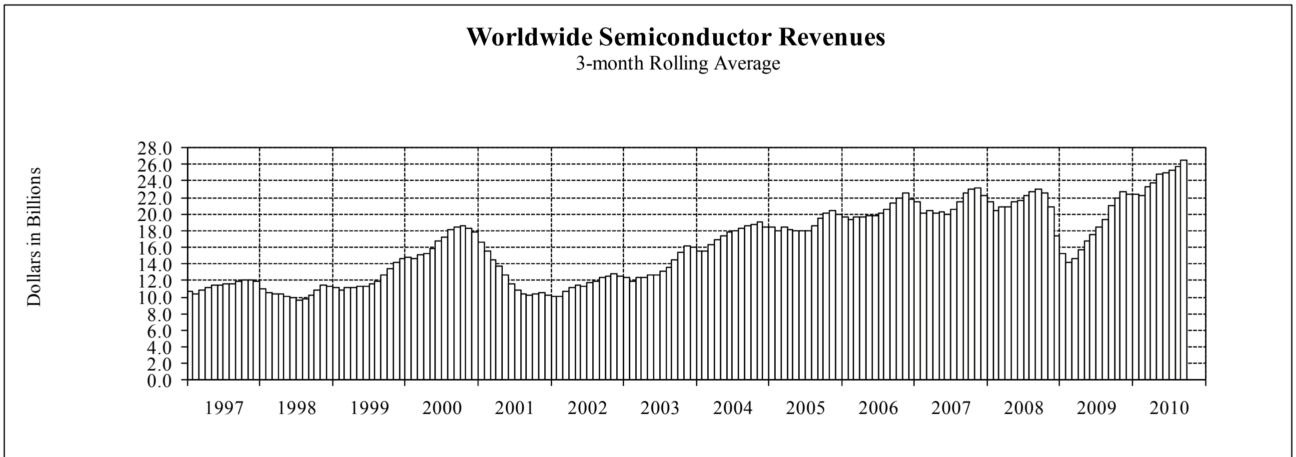

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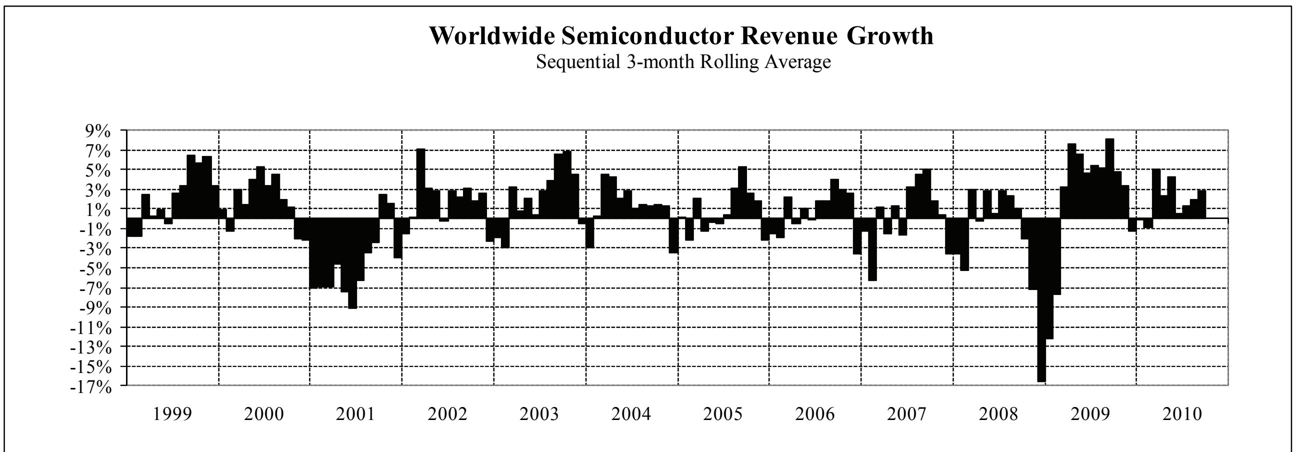

Source: WSTS and Tokeneke Research LLC

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

Sources: Tokeneke Research LLC

***S&P 500 normalized to the SOX**

The Company

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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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