Semiconductors Poised to Exit the Year with a Whimper

Anemic Business and Inexpensive Valuations—Be Verrwy, Verrwy Carewuful

We are approximately three-quarters through the 3Q earnings season as of this writing and the big picture is one of semiconductor sector business weakness and disappointment to investor expectations. There have been some bright spots amid the carnage and many equities appear priced at attractive levels based on fundamental valuations, but I highly recommend caution before investors tread into this current market environment.

The overall chip business environment remains weak as evidenced by industry statistics, reported 3Q earnings, and especially 4Q guidance. Recall that the chip sector was supposed to be recovering by now from last year's counter-seasonal cyclical downturn that hit mid-year, and 3Q has historically been the seasonally strongest period of the year. As so colorfully noted by management during the recent CY 3Q conference call: "So obviously, the macro is still pretty shitty out there."

Sub-Par September: September chip industry sales growth was below average. Semiconductor industry statistics for world-wide sales released by the Semiconductor Industry Association (SIA) yesterday reported a three-month rolling average gain of +2.0% compared to average growth of +3.1% over the last 22 years with a high of +8.2% and a low of -2.5%, which was also the only decline throughout that timeframe. The Americas roared ahead with a gain of +5.8%, followed by Asia-Pacific at +1.6%, Europe up by +0.7%, and Japan with a small gain of +0.2%.

Next month's release of October is likely to be similarly weak given the 4Q outlook provided by companies during the current 3Q earnings season. October is traditionally a solid growth period averaging a sequential gain of +2.6%, a high of +6.8%, a low of -2.0%, and declines only three times during the last 22 years—although all of them occurred during the last four years.

Even More Lackluster 3Q: The SIA numbers also reflected an even-more anemic 3Q with a sequential quarterly gain of +1.8% compared to average growth of +6.5%, a high of +19.9%, a low of -11.7%, and declines only twice during the last 22 years. Growth of +1.8% is consistent with the weighted average revenue growth of the Tokeneke Universe of 103 stocks of +2.0% so far this earnings season.

In addition, 3Q earnings announcements relative to expectations remain very much in the 'mixed' category with a majority of reporting companies reporting a mix of 'missing' and 'exceeding' a combination of reported sales, reported EPS, and revenue guidance relative to investor expectations. Specifically, as of this writing the 'mixed' category totals 51.4%, the 'missed/met' category of losers totals 21.6%, and the 'met/exceeded' category of winners totals 27.0%. See my '3Q Earnings Summary—Week 3' publication for more detail.

That current business conditions are lackluster is not a surprise given negative preannouncements going into the period. Numerically, preannouncements were mixed with six companies expecting upside (ADNC, IDCC, MSPD, SWKS, TSM and TSRA), seven reiterating or narrowing guidance (ALTR, DIOD, NXPI, POWI, SIGM, TXN and UMC), and six going negative: AMD, INTC, ISIL, MCHP, MRVL and OIIM. However, the bad news dominated the information flow as bigger and more notable PC-market-related companies revised expectations by larger magnitudes. And even the positive preannouncements were not that inspiring: IDCC and TSRA had not provided initial guidance; SWKS mumbled something about the high-end of its range; TSM had already indicated strength; smaller MSPD has its own problems and increased expectations from down to flat; and recent IPO ADNC shares got crushed as its expected gains were more than offset by the simultaneous announcement of the expected loss of its biggest customer Apple (oops). The numbers may have been mixed, but the message was clearly negative.

4Q Weakness: 4Q weakness has been the primary factor accounting for the shortfall to investor expectations this earnings season. Specifically, as of this writing the weighted sales growth range for 4Q based on management guidance is -5+1% for a period that has expanded sequentially by an average of +1.7% over the last 22 years, although it has turned negative eight times during that period.

Share Prices Weak, Too: All this bad news has resulted in chip sector share price weakness. The Philadelphia Semiconductor Index Option (SOX) dropped by -4.0% last month, significantly underperforming to the weak

S&P500 and DOW at -2.0% and -2.5%, respectively, although actually besting the NASDAQ by 50 basis points. The vast majority of semiconductor issues declined last month, as well. While the SOX has eked a gain year-to-date, most individual chip stocks have not and the SOX has significantly underperformed compared to broader market indices, as noted in the tables below.

October			
Winners *(29/103)*		**Losers**	
VIMC	27.6%	AMD	-39.2%
ADNC	21.6%	PLXT	-24.7%
AMCC	14.6%	MLNX	-24.2%
GSIT	12.9%	PXLW	-22.7%
SPRD	12.4%	IPHI	-21.5%
average stock -4.3%		*SOX -4.0%*	

YTD			
Winners *(40/103)*		**Losers**	
CRUS	157.3%	TXCC	-69.1%
MLNX	136.7%	AMD	-62.0%
HIMX	81.0%	NLST	-56.2%
IKAN	71.6%	ADNC	-55.7%
RMTR	58.5%	CEVA	-49.9%
average stock -2.0%		*SOX +0.7%*	

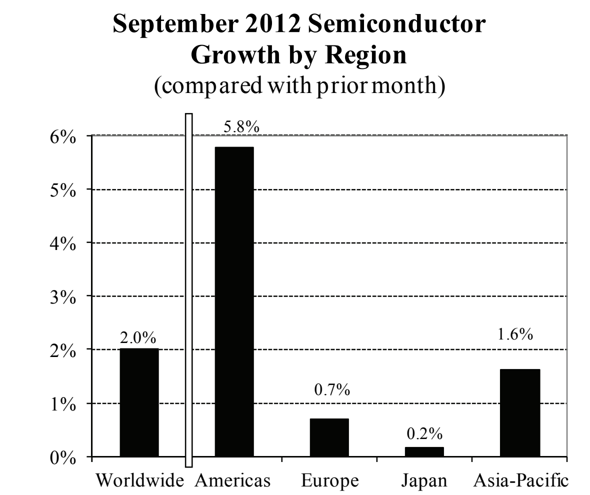
Indices	*Oct*	*YTD*
SOX	-4.0%	0.7%
SMH	-1.7%	2.2%
NASDAQ	-4.5%	14.3%
S&P500	-2.0%	12.3%
DOW	-2.5%	7.2%

Bright Spots: While the big picture is troublesome, there have been some bright spots offering hope as the 3Q earnings season has progressed. Specifically: 3Q growth has actually gotten less-worse, having ramped up to its current +2.0% from -0.8% the first week; 3Q earnings relative to investor expectations has also skewed more positive, with a 'met/exceeded' category of winners currently at 27.0% up from 15.4% the first week; and the SOX index has actually posted gains and outperformed the broader market indices over the last two weeks.

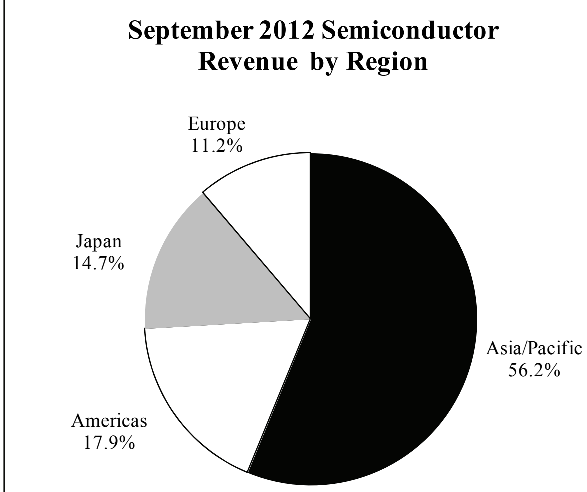
But Don't Get Excited: First of all, the 3Q industry statistics have now been reported and the period was weak. Secondly, the vast majority of individual companies in my 'met-exceeded' category of winners relative to investor expectations are a pretty motley crew of damaged goods—expectations for these un-profitable and barely-profitable turnarounds, restarts, and re-builders have had several months for investors to correct and lower. Not true for the entire list, but very much for the vast majority, in my opinion. Third, the SOX rally of +1.4% last week and +0.6% the prior week is pretty modest on an absolute basis. And finally, 4Q guidance (arguably the most important metric) remains solidly in negative growth territory—and actually has deteriorated to -5+1% from -2.5+4% the first week. The big picture remains one of business weakness and disappointment to investor expectations.

Share prices are certainly attractive on a fundamental valuation basis across the vast majority of issues in the sector. But clearly, deteriorating fundamentals render any argument for opportunistic, value-based investment opportunities problematic. With any luck, positive share price action over the last two weeks may have marked the beginning of a recovery—but I think it's still way too early to make that call. Stay tuned.

—Dan K. Scovel
Semiconductor Analyst



Source: WSTS and Tokeneke Research LLC



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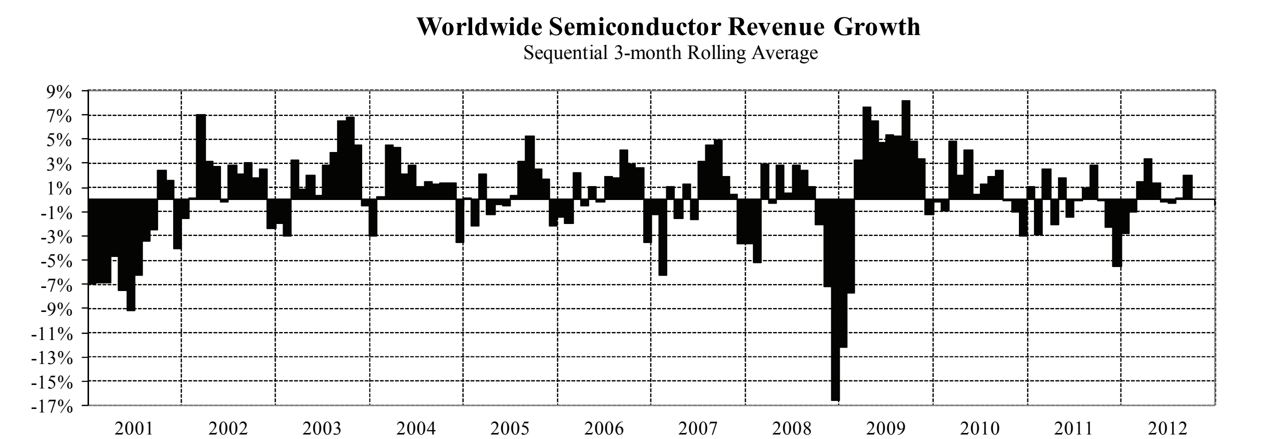
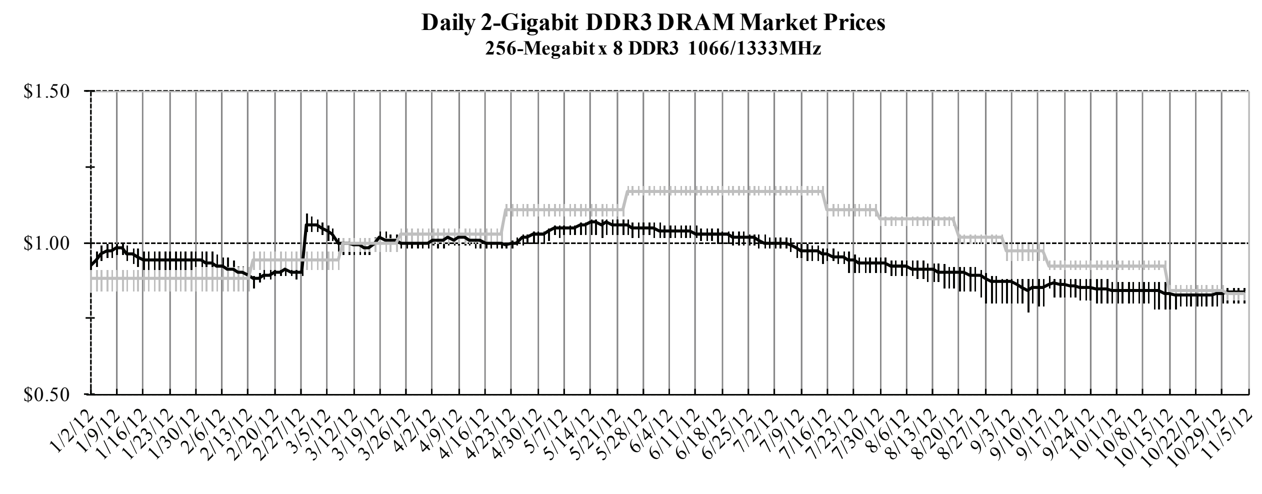


Source: WSTS and Tokeneke Research LLC

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

Source: Tokeneke Research LLC

**S&P 500 normalized to the SOX*



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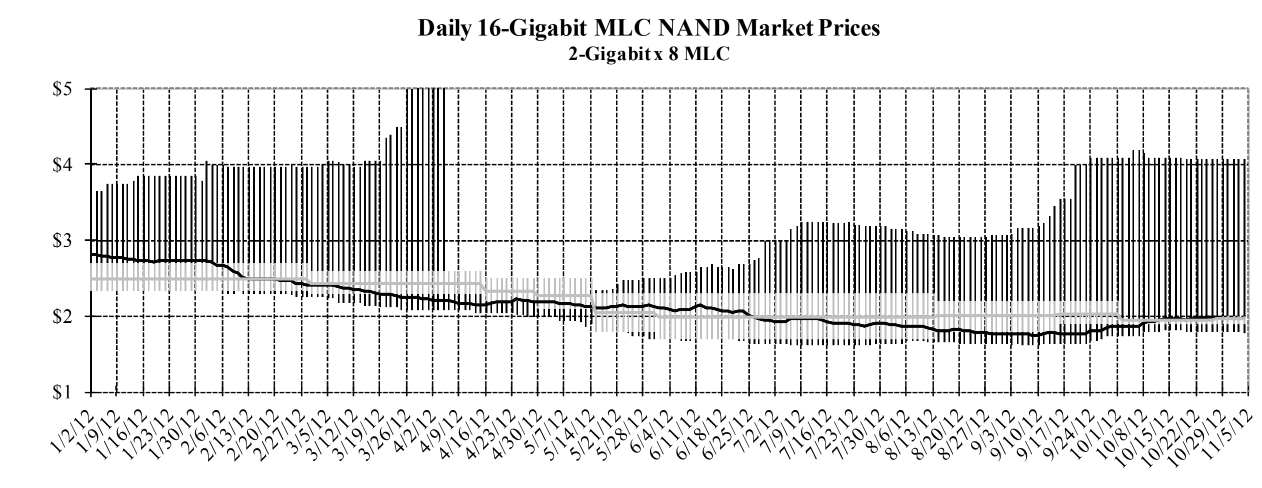

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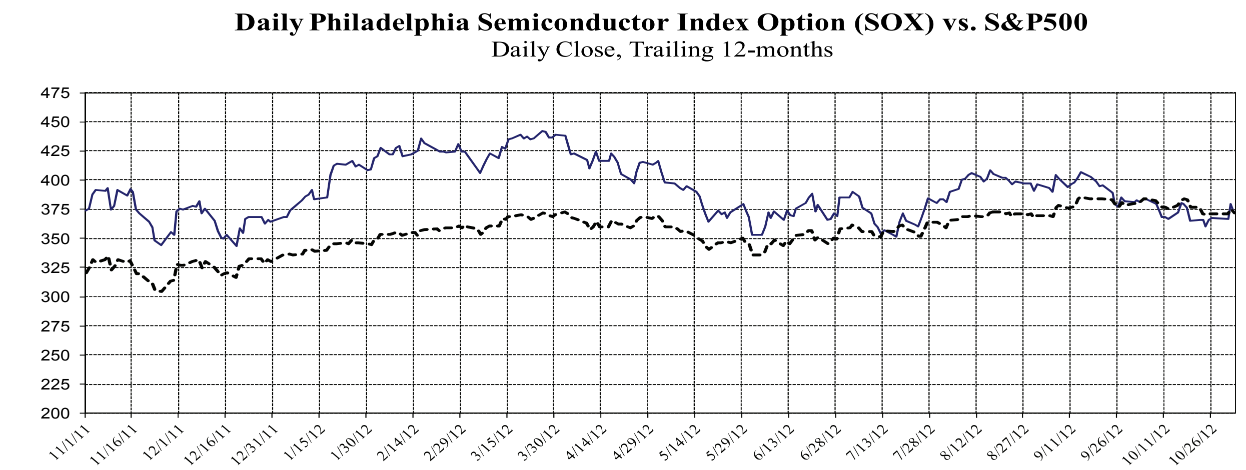

Source: Tokeneke Research LLC

**S&P 500 normalized to the SOX*

The Company

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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 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.

—Dan K. Scovel
Semiconductor Analyst

Tokeneke Research LLC
Rowayton, CT 06853
203-554-4621
dscovel@tokenekeresearch.com
www.tokenekeresearch.com