# SMSC: A Parable of 1Q Chip Sector Earnings

## *Some Good News Amid The Wreckage*

**Summary:** SMSC announced February-ended, F4Q09 earnings last Wednesday, after the close. Revenue exceeded expectations, although the pro forma loss amid restructuring came up short. Management noted that cancellations and push-outs have abated, and strength from notebooks, netbooks and low-end PCs is expected to drive 10% revenue growth this quarter. The shares rallied after-hours but finished the next day down by -$0.37 to $17.91, and I am ambivalent based on fundamentals at this level. I think this release appropriately sets the stage for 1QCY earnings announcements across the chip sector over the next four weeks.

***SMSC F4Q09 Earnings Summary:*** Revenue of $51.2 slightly exceeded guidance and declined by -39.3%. GAAP EPS loss of ($3.30) included $5.2M of on-going restructuring charges (expected to save $6M/quarter beginning now) and a $52.3M impairment of goodwill. The pro forma loss excluding these two items totaled ($0.54), near the low-end of guidance. A revenue break-out is provided in the adjacent table. The company noted healthy PC channel inventory at two weeks, the abatement of push-outs and cancellations, and a slight improvement in end-demand from notebook PCs and low-end PCs, as well as growth from netbooks and smartphones resulting in a book-to-bill ratio or 1.1:1. It guided for revenue growth of 10% and a pro forma loss of ($.28-0.20) per share on flat cash for F1Q10. Cash burn from operations was $3.4M and cash fell by $10.2M to $166.4M. The company carries no debt.

| | FY 2009 | | | |
|---|---|---|---|---|
| *$ millions* | **F1Q 5/08** | **F2Q 8/08** | **F3Q 11/08** | **F4Q 2/09** |
| **By Market** | | | | |
| Mobile PC | 22.6 | 25.7 | 20.2 | 10.2 |
| Desktop PC | 12.1 | 13.4 | 8.7 | 5.1 |
| Consumer Electronics | 21.1 | 23.1 | 23.8 | 16.9 |
| Automotive | 17.0 | 15.9 | 13.2 | 7.2 |
| Industrial/other | 17.0 | 16.0 | 15.4 | 11.8 |
| Intellectual Property | 3.0 | 3.1 | 3.0 | 0.0 |
| Total | 92.8 | 97.2 | 84.3 | 51.2 |
| **Growth** | | | | |
| Mobile PC | -14.7% | 13.7% | -21.4% | -49.5% |
| Desktop PC | -7.6% | 10.7% | -35.1% | -41.4% |
| Consumer Electronics | 10.5% | 9.5% | 3.0% | -29.0% |
| Automotive | 1.8% | -6.5% | -17.0% | -45.5% |
| Industrial/other | 8.3% | -5.9% | -3.8% | -23.4% |
| Intellectual Property | 0.0% | 3.3% | -3.2% | -100.0% |
| Total | -1.4% | 4.7% | -13.3% | -39.3% |
| **Revenue Percent** | | | | |
| Mobile PC | 24.4% | 26.4% | 24.0% | 19.9% |
| Desktop PC | 13.0% | 13.8% | 10.3% | 10.0% |
| Consumer Electronics | 22.7% | 23.8% | 28.2% | 33.0% |
| Automotive | 18.3% | 16.4% | 15.7% | 14.1% |
| Industrial/other | 18.3% | 16.5% | 18.3% | 23.0% |
| Intellectual Property | 3.2% | 3.2% | 3.6% | 0.0% |
| Total | 100.0% | 100.0% | 100.0% | 100.0% |

I am ambivalent on the shares at the current price level. The trailing-12-month price-sales ratio is 1.2 and will likely grow to 1.6-times with the expected revenue decline this fiscal year. Average historical price-sales ratios have been 1.3x, with a high of 2.9x and a low of 0.4x. Earnings remain depressed, rendering P/E valuation problematic.

***Revenue Sucked—But Beat Expectations:*** Revenue of $51.2M was above consensus of $47.2 after original guidance of $45-51M and then a preannouncement of the high-end of that range. Nevertheless, it was still down by -39.3% sequentially. Well, let's call it -37.0% excluding the prior quarter's $3M in royalty revenue from Intel that has expired after five years. So, the mid-point of revised guidance called for -41.5% and the company delivered only -39.3%. Yes, expectations were exceeded. But it sure wasn't by that much given the magnitude of the expected decline, and the company's run rate is now only 53% what it was two quarters ago. I expect reported revenues from across the sector this earnings season to have similar characteristics.

***Pockets of Relative Strength—In the Desert:*** Reported relative strength from netbooks, notebook PCs and consumer and handset sales from fiscal stimulus in China, as well as 3G infrastructure builds there have been widely reported. But again, this is relative to industry-wide sales that have fallen by -40% to -50% in two quarters. It doesn't take much to be strong on a relative basis against a backdrop decline of this magnitude. This is true for SMSC, and it's true for all other chip companies as well.

Netbooks are legitimate new growth products, but look a lot like de-featured notebook PCs that sell for half the price. Growth is very strong off a base of almost zero, but ASPs and total unit volumes compare unfavorably against any segment of the PC market. In general, the good news from this segment needs to double a few more times before it even begins to move the needle on anybody's PC-related sales.

Citing relative strength from notebook PCs is interesting from SMSC, given that it's mobile PC business declined by -49.5% last quarter after falling by -21.4% the prior period. I suspect it's more a sense of relief of getting a few POs after seeing nothing for far too many weeks.

Consumer fiscal stimulus in China appears to be a legitimate sector of strength, as long as we appreciate that it is occurring at the low-end of the handset and consumer electronics markets. Chinese 3G infrastructure, on the other hand, appears truly immune and contrary to the recent downturn. I don't believe SMSC has any exposure here.

***Missed EPS—Violates the Parable:*** The SMSC GAAP loss per share of ($3.30) included restructuring and goodwill impairment that were excluded in the pro forma loss of ($0.54). The good news was that this was within the range of guidance at ($0.55-0.45), but the bad news was two-fold: first, it was a meaningful loss; and second, it missed consensus of ($0.44).

In this case, I don't think SMSC is representative of what we will see this earnings season. While we will certainly see depressed earnings and some losses (much more marginal, at least on a pro forma basis), I actually expect to see a fair amount of earnings upside that may well surprise by a meaningful magnitude. Why? Three reasons: First, managements have cut back hard amid plummeting sales and no visibility—especially after experiencing the tech crash in 2001; Second, I think managements were motivated to under-promise after huge misses the prior quarter; And third, there appears to have been a surprising lack of price pressure—competitive or otherwise (unless your business has been commodity memories like DRAM or NAND flash, anyway). This has already led to instances of favorable product mixes amid the revenue purge actually improving gross margins.

***Outlook Favorable—But Let's Keep Some Perspective:*** SMSC guidance calls for 10% sequential revenue growth this quarter to a range of $55-58M due to strength from notebook PCs, netbooks, and low-end PCs. This is pretty good news for SMSC for several reasons: the bottom of the downturn has been established; SMSC is more than offsetting what is typically a seasonally soft F1Q; and they're doing it without the $3M quarterly royalty they have been enjoying from Intel for a few years. Clearly this is very good news—especially if such growth on a percentage basis were to persist.

However, let's keep some perspective on these numbers. The legitimate good news, in my opinion, is that business has finally achieved a plateau after its recent free-fall. The falsehood would be the belief that this improvement marks the beginning of a recovery. And the dangerous half-truth would be the very favorable comparison with typical seasonal softness. I think it's more of a dead-cat bounce to refill channel inventories that have been bled down to the bone. And an incremental $5M is +10% off a base of $51.2M, but would have been up only +5% from the revenue base 180 days ago.

Seasonality and average quarterly revenue changes measured in basis points are meaningless after a 47% cut in sales. This downturn began during a period of typical seasonal strength and happens to be stabilizing during a seasonal inflection point where 2Q marks a trough in the PC business but a pronounced up tick in the consumer electronics segment. In fact, I think the counter-seasonality aspect of the current business cycle could easily persist throughout the year resulting in an unusually favorable spring and summer followed by a decidedly lackluster fall and holiday period. And all this gyration would be simple normalization following an unusually severe disruption.

***Shares Rally, Retreat, Recover, And Then Fade:*** The SMSC headline on its earnings announcement was revenue above expectations, and subsequent quarter revenue growth also greater than expected. The immediate response to the shares in the aftermarket was a rally—even after it closed the day up by $0.82 to $18.28, or +4.7% amid S&P500 strength of +1.2%. And this strength carried over into the follow days opening at $18.52. However, the shares then retreated to $17.65 during the morning, recovered up to $18.28 in the afternoon, and then faded down to close at $17.91, slightly above the lows of the day during the last hour of trading. The shares closed the day off -$0.37 or -2.0% on a day when the S&P500 advanced by +3.8%. Basically, the stock chased itself around in a circle.

I have been preaching a mantra that chip sector share prices this year are likely to advance and retreat at least a few times as business conditions roll along the bottom of the current downturn amid an elusive recovery. I just thought it was funny to see such a pattern encapsulated in a 24-hour period coincident with SMSC's earnings announcement. Just think how much fun it will be when we have two dozen companies all reporting such a mix of relative pluses and minuses at the same time over the next few weeks. I know I can't wait . . .

 

**Outlook Unchanged:** The semiconductor business has bottomed, although this plateau has occurred at a fairly depressed level and the timing and profile of the ultimate macroeconomic recovery remains elusive. I continue to believe we remain in an equity market environment that will be characterized by rallies and retreats as we roll along this bottom. Near term, I expect a correction in equity markets will offset the vast majority of gains achieved by the sector during its 32% rally last month. I also expect mixed-messages during the 1Q earnings season to fuel this start-again, stop-again trading pattern.

***—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:*** Accumulate as it approaches support around $14, and lighten-up as it approaches my $19 target price.
***INTC:*** I'm not interested until it approaches its recent support level just over $12.
***NSM:*** Also not interested until it approaches a recent support level around $9.50.

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