Still Too Early to Call a Bottom

Plethora of Negative 3Q Preannouncements; Guidance Likely to Disappoint

The bad news is that the semiconductor industry appears to be entering a counter-seasonal slowdown in business conditions during a year of sector underperformance amid the broader equity markets as we enter the 3Q earnings season. But the worse news is the unattractiveness of equities as an asset class as reflected by low trading volume, volatility, and relative underperformance amid the current financial, economic and political uncertainties around the world. There are a couple slight glimmers of hope that indicate we may be approaching a bottom, but it's too early to call—in my opinion. If your investment time horizon can accommodate at least a year or two, then a large number of significant opportunities based on fundamental valuations are currently available. But I think the breadth and depth of current geopolitical uncertainties make for a very dicey investment situation for the foreseeable future.

August Flatness: August was another flat month. Chip industry statistics released earlier this week reported sequential world-wide sales growth of +0.7% on a three-month rolling average basis: the good news is that it wasn't negative (a triumph of low expectations?), but the bad news is that it underperformed on a relative historical basis. August is usually a pretty decent month with average growth over the last 21 years of +1.9%, a high of +5.2%, a low of -3.5%, and it has only fallen into negative territory four times during that stretch. Japan was in nice recovery mode once again with growth of +5.3% following March's disasters, followed by Asia-Pacific swinging positive with growth of +1.1%, the Americas with a decline of -1.6%, and then Europe falling once again by -2.4%.

I expect similarly modest sequential growth when September sales are reported next month as macroeconomic malaise offsets traditional seasonal strength. September is typically quite healthy growing on average by +3.1% with a high of +8.2%, a low of -2.5%, and falling into negative territory only once in the last 21 years.

Flat Year: Flat appears to be the most apt word shaping up to describe this year both in terms of how it relates to industry sales on a monthly basis, as well as forecasted growth for the whole period. I concur with market researchers expecting revised growth expectations reflecting a modest expansion for 2011 in the low-single digits as the year is faces two strong headwinds: the mathematical curse coming off a very strong 2010 with growth of +33%; and deteriorating business conditions as the year draws to a close, despite a traditional seasonal uptick.

3Q Earnings Preview—Not Good: The 3Q earnings season begins this month and is likely to reflect a disappointing mix of announcements not unlike last quarter when guidance largely fell short of expectations, in my opinion. Frankly, this is an easy call given current macroeconomic weakness, worldwide monetary and fiscal uncertainty, and negative company pre-announcements representing a solid one-fifth of the Tokeneke chip sector.

Some 25 semiconductor companies have preannounced revised 3Q expectations over the last few weeks: only one raised expectations (tiny ACTS); two reiterated or narrowed expectations (BRCM and DIOD); and the remaining 22 lowered expectations. To be fair, three of those 22 still expect sequential revenue growth, including AMD, MPWR and MSCC. But the rest have either swung negative from positive or flat, or simply increased the expected magnitude of revenue decline. The parade includes: ALTR, AOSL, BCDS, CAVM, CODE, FCS, FSL, IDTI, IPHI, ISIL, LSCC, PSEM, TQNT, TSRA, TXCC, TXN, VSH, VTSS and XLNX. In addition, the following companies with at least $1B in annual sales have not (yet?) preannounced, but originally guided for an expected decline in sales: ADI, IRF, LLTC, NXPI, ONNN, OVTI, STM, TSM and UMC. On a weighted revenue basis the industry has lost some $500M in revenue from the low-end of expectations, and $900M from the high-end out of $53.5B in quarterly Tokeneke Universe sales reflecting 72% of the total industry.

On a sequential quarterly growth basis, original guidance called for cumulative weighted growth centered at +3.2% (with a range of +0.5% to +5.9%) which has now dropped to +1.9% (with a range of -0.5% to +4.3%). If we take monster Intel out of the picture who is expecting growth of +4+11%, these numbers drop from an original +1.9% (range of -0.5% to +4.2%) to -0.1% (range of -1.8% to +2.0%). A complicated way to describe a flat and fading 3Q.

We also have the benefit of early-reporting companies whose fiscal periods capture two-thirds of the reported calendar period, SMSC and MU (although we just lost NSM to TXN and SMOD having been taken private—again). Unfortunately, both of them disappointed. Early last week SMSC met expected revenue, slightly missed on earnings, but then offered revenue guidance well below the low-end of Street expectations—and the shares declined by -3.8% (albeit on a -2% kind of day). Guidance for revenue down by -7% to -2% reflected expected single-digit growth from consumer (boosted by a recent acquisition) and automotive, offset by declines from PC and industrial markets. PC markets were characterized more generally as flat-ish. MU also disappointed later last week by slightly exceeding revenue, but then missing the low-end of Street expectations for earnings primarily due to weak DRAM market prices (the company does not offer guidance as a general practice). The shares were subsequently pummeled by -14%, although Friday was ugly anyway with broader indices down by -2% to -3%.

Pockets of Strength: To be fair, there are rays of sunshine. From a market perspective smartphones, iPads and servers continue to grow, with Apple leading the charge. In addition, a number of huge chip companies appear to be doing just fine, lead by INTC and QCOM (with 3Q revenue guidance of +4 to +11% and +7% to +15%, respectively). In fact, the following semiconductor companies with over $1B in annual sales all continue to expect sequential revenue growth 3Q as of this writing: ATML, AVGO, BRCM, CY, INTC, LSI, MRVL, MXIM, NVDA, QCOM, RFMD, SNDK and SWKS.

Tech Underperforms Less!: Let's call this 'fatalistic enthusiasm'—the semiconductor sector outperformed the crashing equity markets last month! Woo-hoo! During September the Philadelphia Semiconductor Index Option (SOX) declined by -4.8% while the S&P500 and NASDAQ fell by even more: -7.2% and -6.4%, respectively. While I certainly hope this signifies the beginning of a bottoming for the sector, I am very hesitant to stake that claim at this point as the chip sector continues to significantly underperform relative to broader equity markets for both the quarter and year, as shown in the table below. Notice also the relatively small number of winning stocks for the month, quarter and year across the broader Tokeneke Universe.

September			
Winners *(22/103)*		**Losers**	
NETL	60.3%	SPWRa	-42.6%
TRID	23.8%	IDCC	-33.8%
RMBS	20.6%	TQNT	-33.8%
NPTN	12.8%	NLST	-33.3%
AUTH	12.4%	AATI	-28.0%
average stock -7.2%		*SOX -4.8%*	

3Q			
Winners *(9/103)*		**Losers**	
NETL	19.0%	SQNS	-64.8%
AUTH	18.1%	OVTI	-59.7%
IDCC	14.0%	SPWRa	-58.1%
SPRD	13.9%	ENTR	-53.5%
INFN	11.7%	TQNT	-50.7%
average stock -23.8%		*SOX -17.4%*	

YTD			
Winners *(11/103)*		**Losers**	
SIMO	172.0%	TRID	-70.8%
NETL	53.2%	ANAD	-68.8%
AUTH	30.4%	MIPS	-68.1%
MLNX	19.3%	ENTR	-65.8%
CEVA	18.6%	QUIK	-63.4%
average stock -24.7%		*SOX -17.7%*	

Indices	***Sep***	***3Q***	***YTD***
SOX	-4.8%	-17.4%	-17.7%
SMH	-2.5%	-16.5%	-12.6%
NAS	-6.4%	-12.9%	-9.0%
S&P500	-7.2%	-14.3%	-10.0%
DOW	-6.0%	-12.1%	-5.7%

Opportunities for the Looooong Term: Doom and Gloom continue to be the order of the day throughout the semiconductor sector, as well as the overall equity markets in general as reflected by low trading volume, volatility, and relative underperformance amid the current financial, economic and political uncertainties around the world. That chip sector fundamentals have taken a back seat to asset allocation is not a surprise.

Nevertheless, there are a couple of *slight* glimmers of *potential* hope—and I really mean to underscore <u>slight</u> and <u>potential</u> as in 'too-early-to-tell.' First is the slight outperformance of the chip sector amid last month's carnage across the equity markets, with the SOX down by -4.8% and the SMH's down by only -2.5% as the S&P500 and NASDAQ cratered by -7.2% and -6.4%, respectively. This could be a very early sign of a bottoming. Second is the reported and expected business strength among a number of very large chip companies lead by INTC and QCOM: the strength of their numbers as they now stand are notable and impressive.

Unfortunately, I think it's still too early to call a bottom. First of all, sector and equity markets remain weak and highly volatile regardless of recent chip sector relative outperformance. Secondly, I remain skeptical and skittish of the (as yet un-pre-announced) strength among the INTCs and QCOMs—especially when considering the likelihood of disappointing guidance that may soon be offered. And third, I am frankly somewhat surprised that bad news continues to adversely affect share prices across the sector. After 22 preannouncements of expected weakness, I would expect share prices to already reflect downside risk, and possibly even at least some kind of share price rally as bad news is finally disclosed and interpreted by investors as a relief that it's not worse. I guess I'll blame the INTCs and QCOMs for that at this juncture.

If your investment time horizon can accommodate at least a year or two, then a large number of significant opportunities based on fundamental valuations are currently available. But the breadth and depth of current geopolitical uncertainties continue to make for a highly uncertain investment environment for the foreseeable future, in my opinion.

—Dan K. Scovel
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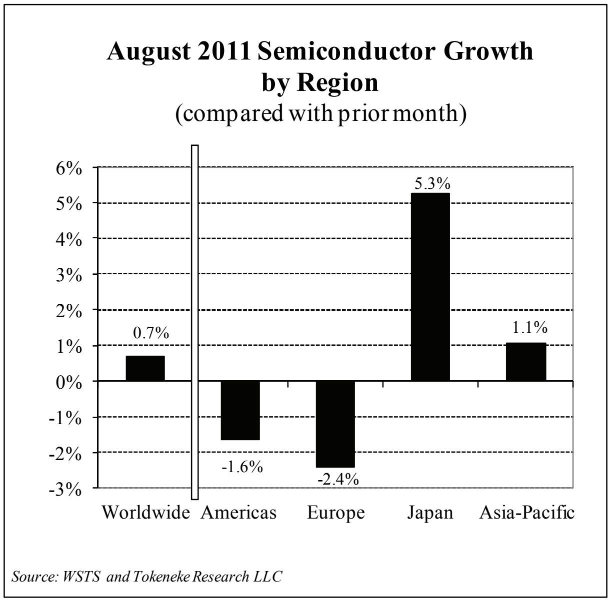
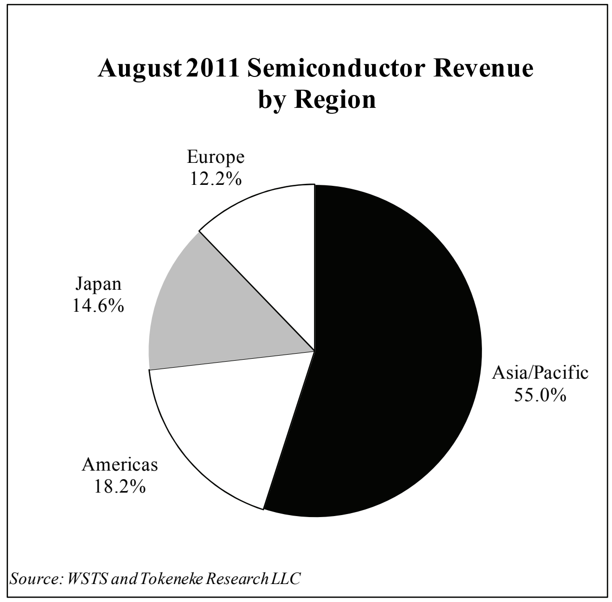
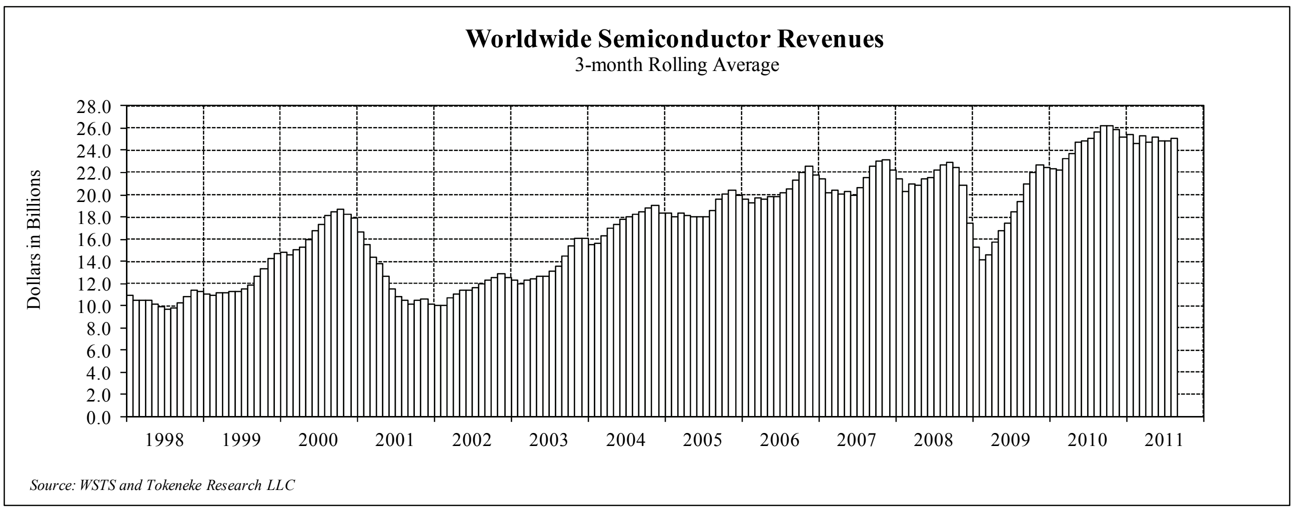
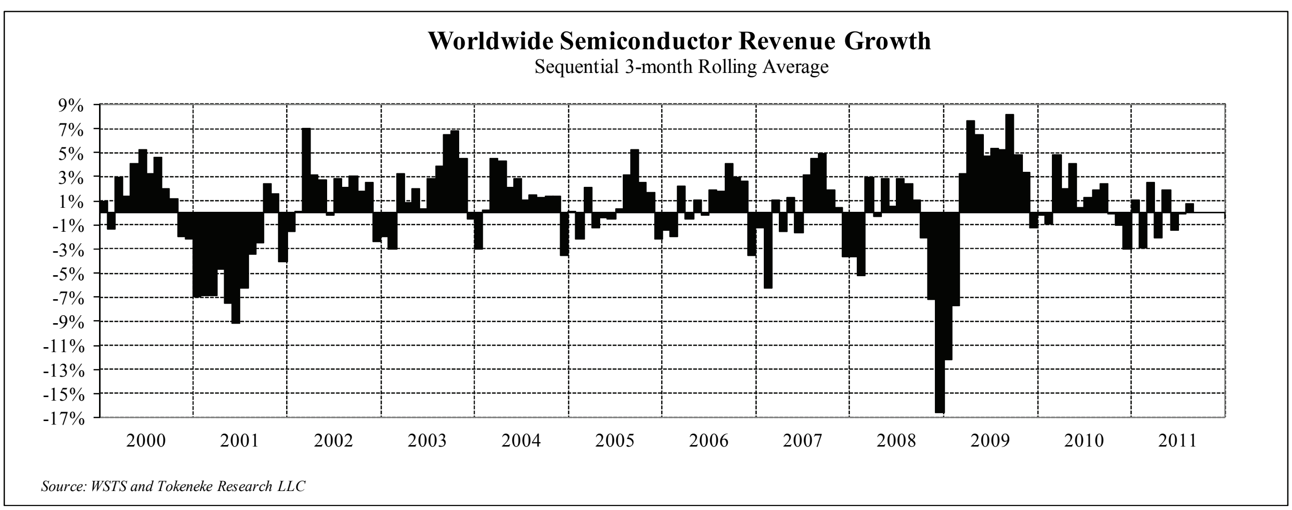
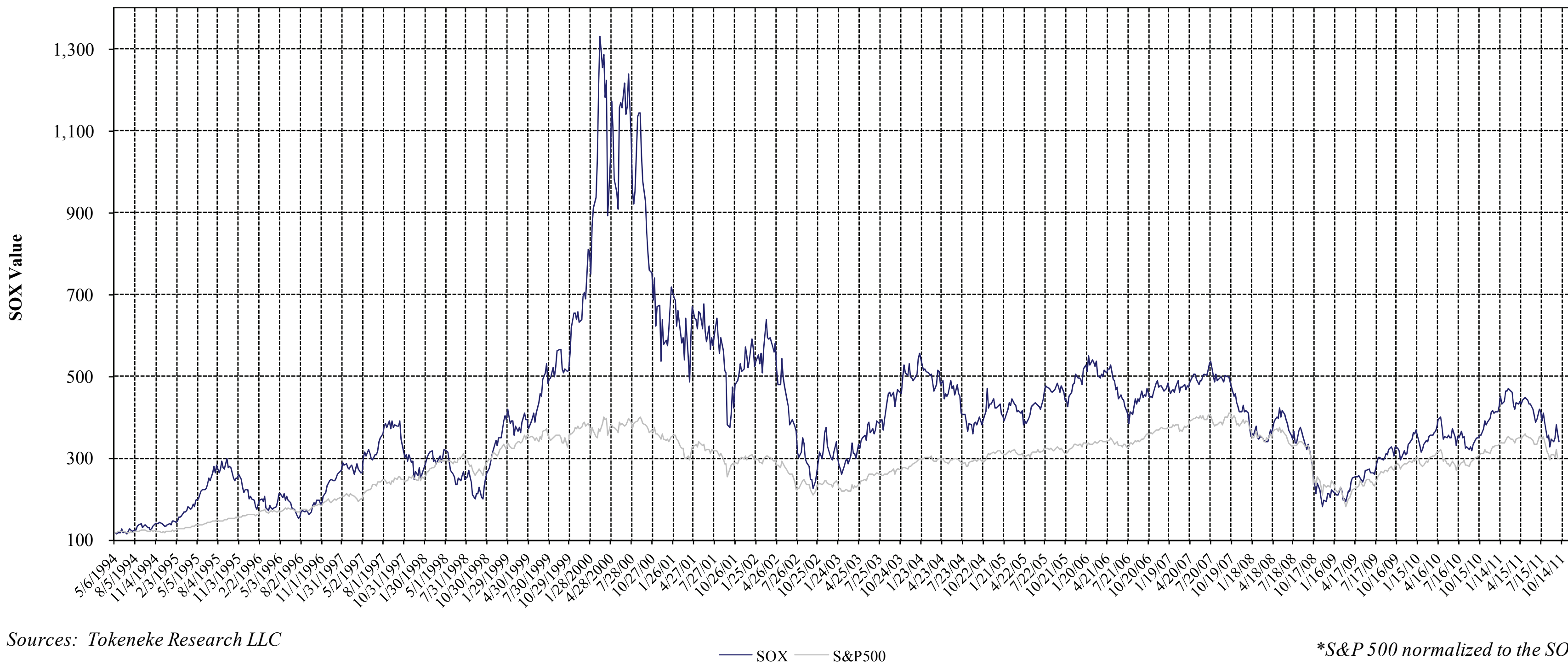

August 2011 Semiconductor Growth by Region
(compared with prior month)
6%
5%
4%
3%
2%
1%
0%
-1%
-2%
-3%
0.7%
-1.6%
-2.4%
5.3%
1.1%
Worldwide
Americas
Europe
Japan
Asia-Pacific
Source: WSTS and Tokeneke Research LLC


August 2011 Semiconductor Revenue by Region
Europe 12.2%
Japan 14.6%
Asia/Pacific 55.0%
Americas 18.2%
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
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
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%
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
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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