For the Want of a Nail

Thai Flood Impact Could be Broader than Expected, Downside Risks Abound

The indirect impact on the semiconductor and electronics industries from flooding in Thailand during October is just beginning to be realized and is likely to further aggravate already soft macroeconomic conditions around the world beyond just disk drives and PCs. This week alone three semiconductor companies preannounced expected shortfall to previous 4Q expectations, and a report out of Taiwan blamed a lack of optical component availability from Thailand for a smartphone chip shipment shortfall last month at MediaTek. I think we will see many more chip companies preannounce expected 4Q downside over the next few weeks.

The direct impact to the electronics industry from the Thai floods has largely been sized and timed, and the recovery has already begun. Basically one-third of the world's disk drive manufacturing was interrupted and won't fully recover until 2Q12, and a small portion (probably less than 10%) of back-end package assembly operations for semiconductor industry manufacturing was hit, and companies scrambled quickly to alternatives that should largely mitigate the impact by next quarter.

But the indirect impact, at least beyond disk drives affecting PCs, has been largely unclear to the vast majority of chip suppliers—pretty much as acknowledged by company managements throughout the 3Q earnings season and extending into the subsequent investment conferences. I think the indirect impact on PCs has been downplayed and is likely to be more significant than most investors expect, and that incremental downside across a number of end markets for a variety of reasons is also likely. While much of this incremental downside that manifests itself over the next few weeks will be correctly attributed to world-wide macroeconomic weakness, I believe some meaningful portion of it will have been caused indirectly by the flooding—whether or not acknowledged or even understood as such by periphery chip makers in the supply chain.

PC Downside: How can PCs *not* get clobbered when one-third of the world's disk drives go missing? Solid-state drives (SSDs) at over 10-times the price are not yet viable alternatives and the drive-less Intel ultrabook is still a few months away from market introduction. Intel has been winning its on-going disagreement with PC market researchers over the last couple of quarters claiming emerging market strength supporting world-wide PC unit shipments greater than IDC and Gartner can count. So, let's guess who will be last on the list for disk drive allocation after the server guys and tier-one PC OEMs get their drives? Answer: all those white-box PC suppliers in China, India and Brazil. Oops. So is INTC a short? Probably not: If life was fair INTC would be pushing $40 a share right now and it would be a short. But at $25 a share, not so much. I'm hoping that an INTC preannouncement of expected 4Q weakness sometime over the next couple of weeks will finally give us a share-price bottom that extends across the sector from which the subsequent recovery rally can be based. So far, that bottom has been elusive as business strength from INTC and QCOM have supported investor hope (reflected in share price valuations) across much of the sector, in my opinion.

Smartphone Downside: Interesting piece on DigiTimes yesterday claiming that Taiwanese chip supplier MediaTek had incrementally light shipments of smartphone chipsets to a Chinese manufacturer last month because that customer could not get ambient light sensors from a company called TAOS to complete the smartphone kit. It turns out TAOS is allocating product due to an assembly shortfall from the flooding in Thailand. In my opinion, this is a perfect example of how uncertainty surrounding the indirect impact of a major event can have a profound impact on seemingly unaffected areas. Frankly, I would be surprised if many other such instances don't occur over the next few weeks. Also, a shakeout is occurring in this space as Apple and Samsung assert leadership while others fall by the wayside (think HTC recently). And this mix of winners and losers is extending to their semiconductor suppliers.

Negative Preannouncements Begin: Three semiconductor companies preannounced negative 4Q expectations in the last 12 hours: TXN dropping revenue growth to -8-4% from -6+2%; ALTR to -16-13% from -11-7%; and LSCC to -17-14% from -9-4%. All blaming broad based weakness, with bright spots from TXN in application processors going into smartphones and eReaders, and strength from Japan as it continues to recover from its earthquake, tsunami and nuclear disasters earlier this year. To be fair, both DIOD and SPRD have reiterated guidance, and Macronix out of Taiwan actually raised its expectations on ROM strength to Nintendo. Nevertheless, I expect a number of additional negative preannouncements from other chip companies over the next few weeks.

Chinese New Year Bust: A few companies were quizzed about Chinese New Year during 3Q earnings conference calls, and the universal answer was that it was too soon for consideration in terms of chip orders or shipments. Are you kidding me? Chinese New Year falls on January 23 next month. The questions—even in early-November—should have been, 'Why haven't you seen any ordering for Chinese New Year yet? And how late will be too late for you to support them?' I predict Chinese New Year will offer only limited upside, if any, to the semiconductor and electronics industries next quarter. The timing could not be worse as it occurs in the midst of a cyclical downturn and world-wide banking crises as the worst of the disk drive shortfall affects white box PC OEMs at the bottom of the allocation list. Other than that . . .

Downturn, Adverse Seasonality, Banking Crises: The semiconductor industry is in for a rough couple of months, in my opinion. The current cyclical business downturn occurred during the seasonally strong second half of 2011, which means even if it bottoms early in 2012 the recovery will face seasonal headwinds during the weak first half of the year. It will also take until sometime during 2Q for the disk drive shortage and other affects from the Thai floods to fully recover. And just throw in worldwide macroeconomic weakness as well as governmental monetary and fiscal stress for fun.

What I am looking for from the semiconductor sector in the equity markets is a bottoming. This has been elusive as bad news continues to hurt stocks. Much of this has to do with the lack of investor attention on industry fundamentals due to the preoccupation with asset allocation and sovereign debt. But even cursory attention to the sector is veiled by the strength from behemoth industry leaders INTC and QCOM masking more prevalent underlying weakness. While weakness from QCOM is probably asking for too much at this point, I think a wake-up call to investors from INTC could go a long way to lower investor expectations throughout the group. And this subsequent bottom—when bad news no longer hurts share prices—will mark a wonderful entry point.

2012 Upside: The good news is that 2012 will be great year for the semiconductor industry as the cyclical business downturn transitions to a recovery, and at least a good year for tech stocks as chip sector share prices bottom and then rally ahead of that recovery. And, with any luck, significant changes in US regulatory, taxation and fiscal policies.

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