

OmniVision Margin Insight

OmniVision (OVTI, \$14.26 -0.33, Buy, Target \$30, FY13: \$1.25 on \$1,407M, FY14: \$2.04 on \$1,456M)

Gross Margin Insight: The primary culprit to current gross margin weakness is the new OmniBSI-2 technology that is used to manufacture last quarter's tremendously popular 1.3Mp device in smart phone applications. Long term, this technology is likely to offer significant competitive advantages in terms of cost and volume (in my opinion) given the first-time employment by OVTI in the manufacturing environment at TSMC of 300mm wafers, 65nm line widths, copper metallization, 1.1-micron pixel sizes, and the use of bulk silicon wafers rather than more expensive SOI (silicon-on-insulator). The bad news is that such benefits will take 'time' and 'volume' before they can be realized. The good news is that the time and the volume thresholds are likely to occur over the next couple of quarters rather than years.

Pro forma gross margin of 16.8% last quarter was quite the disappointment, and management would only comment that 'time' and 'volume' were required for some kind of unspecified recovery with an emphasis that time was not imminent or near-term. The bad news is that management is unwilling to share a target gross margin or operating model target due to wildly volatile consumer market exposure, and the details of its arrangement with TSMC regarding its new OmniBSI-2 technology (the gross margin culprit) remain confidential.

However, following a discussion with management yesterday it turns out that 'time' will likely be measured in quarters rather than years or months, and 'volume' appears to be tied to commitments like orders rather than the promise of a forecast. It seems to me that the cost sharing arrangement the company has with TSMC is a kind of modified cost-sharing 'take-or-pay' deal (my interpretation, not management's words) with limited gross margin downside as well as upside potential. Gross margin probably won't get any worse (thank goodness), but the timing and magnitude of upside will depend on actual factory loading—a factor that OVTI won't commit to until it has customer orders, or at least high-confidence forecasts. With any luck I think this could occur within a couple of quarters, but it could also take longer—it will all depend on customer/market demand.

The ill-defined 'time' factor originally caused me concern. My fear was that 'time' was a euphemism for depreciation, and that depreciation is an accounting construct that tends to be measured in years rather than months or quarters. However, management clarified that 'time' is not measured in years, and it seems to me that the arrangement with TSMC somehow shares capital costs in a way that will not necessarily limit the timing of upside from associated depreciation to the accounting calendar. The implication is that it is accelerated in some way.

No change to my earnings model or Buy recommendation or target price, although the above insight significantly alleviates the potential for any downside risk—in my opinion.

—Dan K. Scovel
Semiconductor Analyst

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

CONFIDENTIAL

Copyright © 2012 Tokeneke Research LLC. All rights reserved. This report is for information purposes only and does not constitute a solicitation or an offer to buy or sell any security or to participate in any investment or trading strategy. Opinions expressed in this report reflect the judgment of Tokeneke Research LLC on the topics addressed as of the date of the report, and are subject to change without notice. Tokeneke Research LLC makes every effort to use reliable and comprehensive information but makes no representation that the information in this report is accurate or complete, nor does it undertake to update or revise this report at any time or for any reason. This report contains forward-looking statements that involve risks and uncertainties, both known and unknown, as well as assumptions that, if they do not fully materialize or prove incorrect, could cause actual results to differ materially from those expressed or implied by such forward-looking statements. Actual results and trends may differ materially from historical results or those projected in any such forward-looking statements depending on a variety of factors. This report does not provide individually tailored investment advice and has been prepared without regard to the specific individual financial situation, objectives and needs of those who receive it. Securities discussed in this report may not be suitable for the reader. Tokeneke Research LLC and/or Dan Scovel may have a long or short position in the securities of a company or companies mentioned in this report and, at any time, may change that position. Tokeneke Research LLC accepts no liability whatsoever for any loss or damage of any kind arising out of the use of any part, or all, of this report. All company and product names mentioned in this report may be trademarks or registered trademarks of their respective holders and are used for identification purposes only. Reproduction or distribution of this report, even for internal distribution, is strictly prohibited unless specifically authorized by Tokeneke Research LLC.