

The Semiconductor Industry continues to be ranked in the top quartile of all industries under Value Line coverage. This doesn't come to much of a surprise to us, given that this industry is highly cyclical in nature, and thus has benefited from an improving domestic economic landscape. We believe that many of the companies under our review posted strong year-over-year gains in revenues and earnings in 2010. Strong supply and demand fundamentals fueled healthy bottom-line gains for most chip companies.

How Will The Chips Fall In The Near Term?

Last year was the strongest ever for the Semiconductor Industry. According to the Semiconductor Industry Association (SIA), worldwide sales of chips increased nearly 32%, to a record \$298.3 billion for the year. The prior year, it should be noted, made for relatively easy comparisons, as the U.S. was mired in a recession in the first half of the year. Recovery was strong in the chip sector, thanks to the fact that semiconductor components are used in a wide range of consumer electric devices. Consumers are often upgrading their cellular base stations, laptops, personal computers, and digital televisions. And a strengthening domestic economic backdrop added to their consumer dictionary purchasing levels last year.

The current state of affairs in the chip sector can best be described as a mixed bag, from our perspective. The December and January book-to-bill ratios for the Semiconductor Industry were .90 and .85, respectively. This implies that orders received were less than orders billed each month, which is generally viewed as a sign of slowing growth. Hence, we look for the top line to grow at a mid-single-digit clip this year, a far cry from last year's more-than-30% gain. However, given that last year was a record one for the industry, revenues are likely to be strong on an absolute basis.

There are many factors driving still-strong results in the chip industry. For one, unemployment levels, while still high, have come down from recent peaks. Hence, we look for consumers to continue to purchase the latest technological gadgets, as their purse strings likely loosen. Fourth-generation cellphones have been launched this year, which will help boost results. Consumers generally upgrade their cellphones every two years or so, on average.

Corporate earnings have generally snapped back from their recessionary doldrums. With the domestic economy

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likely to improve at a 3% or so rate, we believe that many companies will boost their IT-related budgets this year. There will likely be some pent-up demand for infrastructure and network upgrades, in our view.

The Japanese earthquake and tsunami that occurred a few weeks ago have unfortunately caused immense damage in that country. Some chip companies we cover will experience production disruptions and delays resulting from the catastrophe. We believe that this may help chip pricing in the near term, as supply conditions are constrained.

The Importance Of Strong Balance Sheets

A healthy balance sheet is very important to companies in this industry. One line item that we look at with great interest is cash and equivalents. This is vital to semiconductor companies for a few reasons. First, cash comes in particularly handy during difficult economic times. During such scenarios, we pay special attention to a company's cash-burn rate, or the amount of cash that is utilized from one quarter to the next. Cash can also be used for share repurchases, bolt-on acquisitions or, less likely, for dividend payouts. Many chip concerns under our coverage don't pay a dividend, as they use funds for capital spending and research & development purposes. R&D is vital for a chip company's success, and the recent extension of the tax credit related to this initiative is a plus for the industry. Most chip companies have a moderate debt level (35% or less of total capital).

Semiconductor Prospects For 2014-2016 Horizon

Many companies under our review have seen their earnings (and subsequently share prices) recover over the past year or so. However, there are still many stocks that offer alluring 3- to 5-year appreciation prospects. Manufacturing efficiencies will likely boost profit margins over that time frame.

Conclusion

We suggest that investors study the reports on the pages that follow this overview to target those equities that meet their individual risk/reward profiles. Semiconductor stocks are typically volatile, so we advise that only more-aggressive accounts look here.

Alan G. House

Composite Statistics: SEMICONDUCTOR INDUSTRY

2007	2008	2009	2010	2011	2012		14-16
115710	113270	99955	130000	137000	145000	Sales (\$mill)	170000
30.3%	29.6%	25.3%	28.0%	28.5%	30.0%	Operating Margin	34.0%
14303	14672	14801	15200	16000	17000	Depreciation (\$mill)	19500
16756	11803	6887.4	14000	15000	16500	Net Profit (\$mill)	22000
23.0%	34.4%	27.8%	28.0%	30.0%	30.0%	Income Tax Rate	30.0%
14.5%	10.4%	6.9%	10.8%	11.0%	11.5%	Net Profit Margin	13.0%
55269	45751	49954	55000	57500	60000	Working Cap'l (\$mill)	62500
18427	19768	17491	18500	20000	22500	Long-Term Debt (\$mill)	24000
118088	101482	105631	120000	125000	133000	Shr. Equity (\$mill)	165000
12.5%	10.1%	5.9%	10.0%	11.0%	10.5%	Return on Total Cap'l	11.5%
14.2%	11.6%	6.5%	11.5%	12.0%	12.5%	Return on Shr. Equity	13.5%
8.6%	4.5%	NMF	5.5%	6.0%	6.5%	Retained to Com Eq	7.5%
40%	61%	106%	70%	60%	55%	All Div'ds to Net Prof	50%
23.2	25.4	36.7	25.0			Avg Ann'l P/E Ratio	20.0
1.23	1.53	2.44	1.60			Relative P/E Ratio	1.35
1.7%	2.4%	2.9%	2.0%			Avg Ann'l Div'd Yield	2.0%

Bold figures are Value Line estimates

