GILDER TECHNOLOGY REPORT

Special Report

Options Expense Fall-Out:

2 Stocks to Buy, 2 to Avoid

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The supreme buy signal of "blood in the streets" beckons us to examine two *GTR* companies. We're not talking about the war with Hezbollah or Osama. It's combat with the local constabulary that seems to be consuming some of our companies. Our advice: Don't get distracted by the march of muckrakers. Instead, listen to the technology and play the paradigms. We can't forecast the outcome of furtive options probes, but we can detect when a company is realigning itself inside or outside the telecosm.

Boomtown

A fabless designer of media chips, Israeli-based **Zoran** (ZRAN) was bombed twice early in July, prior to the Hezbollah hostilities. In one day the company received a grand jury subpoena from the U.S. attorney for northern California, and the SEC began an "informal" inquiry. Boom, boom. A third hit came for investors later in July when Zoran released an abbreviated second quarter report with full financials to follow pending the outcome of an internal review of stock options practices. The review is still in progress and for now we must live with the company's paltry disclosure that quarterly revenue rose to $122.3 million excluding litigation proceeds and that cash and investments came to $265 million. Product and sales trends were also highlighted.

The day after the abbreviate second quarter report, Zoran sank like a stone. Already down by a third from its high near $30 in April, the stock dove over 25 percent to $14.14 during the first half hour of trading. You'd have thought the company's research center in Haifa had taken a direct Hezbollah hit. The straw that broke Zoran's back may have been a projected third-quarter revenue rise that likely looked low-cal to growth-hungry traders. With essentially no quarterly financial data to go on … with the feds and the SEC firing at once … with uncertainty over past financials … and with no one to talk to, Zoran quickly became Noran.

We have no special insight into how Zoran will fare in the options war. But the second-quarter press release gave us no reason to believe that Zoran is faltering, despite the distractions. Sales increased 29 percent over the year-ago quarter and 9 percent sequentially (significantly faster than the forecast 6 percent) driven by sales into the emerging markets for digital cameras and digital TV as well as DVDs. And the strong balance sheet is getting stronger.

Management expects another 8 percent sequential revenue rise this quarter. But it's usually Zoran's strongest quarter and an already spooked Street isn't happy. Consider, however, that if the company had merely met second quarter guidance, it would be predicting a better 11 percent sequential rise for the third quarter, with no difference in the end result. After the April call, we estimated earnings for this year of $1.12 (up 84 percent over

2005) based on the assumption that sales would rise 6 percent this quarter and then *remain steady* the rest of the year. Clearly the company has exceeded that scenario. Yet when it bottomed-out at $13.69 in July, the stock was trading at a pitiful PE multiple of 12 times the conservative and now outdated $1.12 estimate.

Zoran has recovered some since and now trades around $16, still a meager 14.3 times our low-ball forward earnings. Yet the company continues to ascend rapidly into the emerging digital-media markets for cameras, handsets, TVs, DVDs, and printer imaging. At the Photo Marketing Show last spring, Zoran powered over 90 new digital-camera products from companies such as Samsung, Pentax, and **Kodak** (EK).

Long-term, probably more important than Zoran's skirmish with regulators is its battle with competitors, and savvy investors will keep a keen eye on formidable competitors **Texas Instruments** (TXN), **Broadcom** (BRCM), **STMicroelectronics** (STM), and **Trident Microsystems** (TRID) while putting options on the backburner.

While Wall Street looks for a landmine, Zoran at these prices could well turn into a gold mine.

March of the Margin Brigade

Can **Sigma Designs** (SIGM) retake 50 percent gross margins? CEO Thinh Tran says yes, but the battle back will probably be harder for him than settling his options war. Buoyed by burgeoning sales of media processors into IPTV set-top boxes, Sigma's top line bulged 36 percent sequentially during the second quarter. No surprise to *GTR* subscribers, the blowout results reflected Sigma's saturation of the market combined with accelerating deployments of IPTV by telcos following major broadband rollouts. As we've been preaching for the better part of a year, by plunging into the market early and putting all the various standards on one chip, Sigma achieved a real edge against Broadcom, TI, **Intel** (INTC), and others, who assumed they could wait until standards were settled.

To date, CEO Thinh Tran has encountered STMicro as the only competitor—barely worth a mention—in set-top boxes. And in the Blu-ray market, only Broadcom shows up. During the next three months, several manufacturers are planning to launch Blu-ray players running on Sigma processors. Expect "meaningful" shipments during the holidays and "substantial volume" next year as Tran adds another revenue ramp parallel to his set-top run.

Building on its Blu-ray incursions into many of the world's major consumer electronics firms, Sigma expects that in the future those companies will design its chips into scores of other products. Meanwhile, Sigma will begin to leverage its Blue7 acquisition this fall as it samples its first ultrawideband products to be followed by volume shipments next year. Other market segments are also showing signs of strength, notably chips for handheld portable media players, which contributed to 20 percent of sales in the quarter.

With cash and receivables increasing $2.2 million sequentially to $35.6 million, Sigma is showing signs that it has the financial and managerial resources to handle surges and swells without getting tossed back to Wall Street. On the foundry side, supplier **Taiwan Semiconductor** (TSM) assures Sigma that its fab is ready to roll.

By now you might be wondering if CEO Thinh Tran leads a charmed life. We hope he does, because looming is his company's confessional on past stock option grants. With the internal inquisition ongoing, Tran could only

blow smoke signals about second-quarter expenses and earnings, and he may miss the regulatory deadline for filing his quarterly report. Also giving Tran options reflux are the SEC, with an inquiry of its own, and a shareholder lawsuit.

However, unless Tran and company are crooks, we believe that the options mess will turn out to be a red herring for long-term holders of this stock. Of much greater concern is gross margin, which continues to lag expectations. In May, Tran projected about 49 percent for the second quarter and a slow return to the low 50s during the last half of the year in response to a potpourri of planned cost reductions and predicted product mix. What we got instead was 46 percent last quarter (if we read the smoke signals right) and a gradual return to 50 percent early next year.

Looking back, operating income has lagged accelerating top-line growth over the past year as gross margin plunged from 69 to 46 percent under the pressure of volume pricing. But volume pricing means volume orders with sticky customers. Thus, paramount is Sigma's ability to build on its runaway technology lead and thus continue its sales crescendo through next year and beyond. If we restrict our horizon to the fiscal year ending next January, we find that the stock isn't cheap—even using generous projections.

Based on inventory builds and management's ruminations on product and sales activities, we anticipate another 30 percent sequential sales swell this quarter, despite Tran's 15 percent forecast, followed by a 10 percent increase in post-holiday January. That catapults revenue for fiscal 2007 to $90 million, a whopping 3 times fiscal 2006 sales of $33 million. Granting management's latest gross margin and expense guidance (ex options expense), earnings are on track to reach 40 cents per share this year as this quarter's 5 cents grows to 20 cents by January. At the recent price of $15, that gives the stock a strong forward PE of 38.

But if Tran fends off STMicro, Broadcom, and others; bursts open Blu-ray and Blue7; and keeps on funding the future using cash flow from operations, revenue could reach $185 million next year (based on quarterly revenue rises of 10 percent, 30 percent, 30 percent, and 10 percent) with earnings of $1.80 for a stock price of $54 at a PE of 30.

And what about life after television in 2008?

Before you celebrate, don't forget Tran's formidable problems. Plummeting gross margin indicates that competition must already be knocking, though faintly. Also, be on the lookout for signs that Sigma's margin problem stems from management missteps. If the company can't cope with explosive growth, margins could fall further, necessitating a plunge back into the market for cash, something we don't currently anticipate. Keep the faith, but also keep your eye on the competition, the balance sheet, and the consumer.

Fighting on Too Many Fronts

Overwhelming Broadcom's options difficulties are a passel of more potent problems. In April, we called Broadcom a dilution demon—shares had been diluting at a brisk 15 percent per annum. At the time we estimated that continued dilution at that pace would wipe out any possibility of an increase in earnings per share this quarter if, revenue were to rise within bounds of guidance, which it did. Continued flatness on sequential EPS would have set Broadcom on a path toward $1.44 for the year. But that would have required more sales upsides. With next quarter's forecasted fall back to first quarter's sales,

the company has now slipped below $1.44.

In addition to dilution, holding back earnings growth yet further are falling gross margins and rising operational expenses. Broadcom can't fill in the financial details until it completes its internal review of options grants policies, but even this sketchy information is enough to warn us that there are operational problems beyond backdating—itself spooking investors fearing a delisting or management shakeup. In addition to margin pressures, those problems include a pending inventory correction.

Specifically, Broadcom blames its anticipated third-quarter slump on inventory builds across up to half of its products and markets. To allay fears of a protracted slowdown, management gave an uncharacteristic two-quarter outlook, forecasting fourth-quarter sales to surpass the second-quarter's record. But Broadcom has such a potpourri of markets and customers that it may be wise not to rely on such a forecast.

More reliably, we still believe that Broadcom has a good shot at continuing its ascent into the teleputer and life-after-television paradigms if it continues to innovate into mounting markets for VoIP, digital TV, GigE, 10 GigE, and residential broadband gateways. For instance, second quarter growth was led by broadband and wireless, with enterprise networking flat. The company noted particular strength in DSL, cable set-top boxes, digital TV, HD DVD, and wireless LANs.

A big problem for Broadcom may be its ability to transition from a fading 2G wireless business to 3G, where its willingness to litigate against giants **Qualcomm** (QCOM) and TI is an indication it may be having difficulty. On the conference call, management essentially admitted that 3G is not yet ramping. Clearly, the costly litigation must be distracting them, along with the backdating issue, which includes an "informal" SEC investigation.

The stock looked pricey at $43.65 in April at a forward PE of 30. After taking into account ongoing dilution, Broadcom needed to increase its top line 10 percent per quarter to earn its PE ratio, which would have nudged the stock up just 20 percent. Well, forget that. But even at its recent $28 the stock still trades 19 times over the now unreachable forward EPS of $1.44. Broadcom's troubles are many at the moment, and you should probably want to wait until the dust clears before making a move.

Falling into the Digital Ditch

Way back in November it looked as if **Analog Devices** (ADI) had escaped the options imbroglio when it reached a tentative settlement with the SEC. The proposed ruling is so minor, it leaves historic financials unscathed. But then in May, the U.S. Attorney for the Southern District of New York subpoenaed options records going back to 2000. Meanwhile, the SEC has yet to ink a deal.

Too bad those aren't the biggest problems for the second largest standard analog semiconductor company behind Texas Instruments.

Third quarter (July) sales increased 3 percent sequentially, a downside surprise reflecting weakness in the computing and handset markets. Consistent with its competitors, ADI is forecasting a feeble quarter to follow, most likely flat. Of note on the upside was a surge in analog sales into plasma and LCD television products. Overall, high-margin analog continues to grow, up 15 percent over the year-ago quarter and 4 percent sequentially.

Of greatest concern is the struggling digital signal processor or DSP business, a problem we have been warning about for over a year. Excluding the sale of the Fusiv line to Ikanos two quarters ago, DSP revenue rose 20 percent over last year and 3 percent sequentially. That seems

to compare well to analog until you realize that digital is barely breaking even.

Most challenging has been the special-purpose DSP business, which grew just 7 percent compared to last year and declined 8 percent sequentially. By contrast, general-purpose DSP ascended 15 percent on the year and 11 percent sequentially. This makes attractive the idea that ADI should shed special-purpose digital only. After all, ADI ranks second only to TI in DSP sales, and management claims that a crescendo of general-purpose design wins are moving into production.

However, holding onto DSPs has proved expensive, not only because the unit is unprofitable but also because it has distracted the company from bread-and-butter analog. For instance, with the rise of portable electronic devices, power management has become the fastest growing area in analog. Yet ADI's power-management sales have been trending flat and contribute to only 6 percent of revenue. Late to this intensely competitive market in which margins are already weakening, CEO Jerald Fishman now needs to cast with the premier producers to reel in margin-worthy catches.

Elsewhere in analog, data converters and amplifiers are ADI's mainstay, contributing to just under two-thirds of total sales. These products probably command the highest prices in analog, and ADI leads the industry in the high-performance variety. But with 2,000 kinds of converters and 56,000 customers, ADI can, at best, expect to grow with the market. Fortunately, in an analog world that needs increasingly to link to digital processors, applications for converters will proliferate.

But *unfortunately* for ADI, National Semiconductor (NSM) appears to be taking share—during the first 11 months of fiscal year 2006 ending in May, National's standard linear sales grew 20 percent, with converters up 40 percent and amplifiers and power management each up 25 percent. Fishman should take a hint from CEO Brian Halla's success at National, chuck noncore digital, and fully leverage his forte in ascendant high-margin analog where he must keep up with **Linear** (LLTC), **Maxim** (MXIM), National, and **Intersil** (ISIL)as well as TI. While Halla's operating margin jumped over 11 points over the past year to 35 percent and may eventually move higher, Fishman is hoping for 30 percent—someday; despite recent fab consolidations, he expects operating margin to edge away from his long-term goal during the current quarter, slipping sequentially to 26 percent from 27 percent.

No thanks to operations, EPS should still grow significantly faster than revenue this year. That's because the company has been aggressively repurchasing shares and because interest income has been bulging. Based on management's forecast, revenue for fiscal year 2006 ending October should rise 8.5 percent over 2005, almost making up for last year's 9.3 percent slide off of 2004. Yet EPS, excluding noncash charges, should increase 29 percent over last year to $1.63. That's even up 12 percent over 2004, which saw slightly higher sales.

At $31, the stock trades at 19 times anticipated earnings for fiscal 2006. Buoyed by long-term net cash of $2.4 billion, no debt, buybacks, and ascending analog markets, that might appear attractive. But the tepid top-line, distracting digital, and power-management struggles combine to give us pause. Even ADI itself expects operating income to grow just 4.5 percent per year over the long-term based on a hoped for 15 percent per year rise in revenues and that elusive 30 percent operating margin.

Until management becomes more decisive and visionary, we will stick to the sidelines. ■

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