Zacks Small-Cap Research

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Silicom Limited

(SILC-NASDAQ)

SILC: Growth Slows But Sell Off Overdone: OUTPERFORM

OUTLOOK

Silicom engages in the design, manufacture, marketing, and support of add-on cards used to boost the performance of its customers' servers and network appliances. As a component supplier, it is benefiting from the shift to cloud and virtualization as these users and vendors seek to minimize costs. Its recent agreement with Intel will now allow it to sell white label solutions to cloud customers such as Facebook, Google and Amazon. .

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	09/09/2010
Current Price (04/02/14)	$47.90
Six- Month Target Price	**$66.00**

SUMMARY DATA

52-Week High	**$73.00**
52-Week Low	**$29.38**
One-Year Return (%)	**59.45**
Beta	**1.24**
Average Daily Volume (sh)	**102,048**
Dil. Shares Outstanding (mil)	**7.3**
Market Capitalization ($mil)	**$344**
Short Interest Ratio (days)	**0.4**
Institutional Ownership (%)	**22**
Insider Ownership (%)	**25**
Annual Cash Dividend	**$1.00**
Dividend Yield (%)	**2.09**
5-Yr. Historical Growth Rates	
Sales (%)	**30.3**
Earnings Per Share (%)	**40.3**
Dividend (%)	**N/A**
P/E using TTM EPS	**18.4**
P/E using 2014 Estimate	**16.9**
P/E using 2015 Estimate	**14.5**
Zacks Rank	**3**

Risk Level	**Average**
Type of Stock	**Small-Blend**
Industry	**Computer Networking**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2012	10.1 A	10.4 A	11.5 A	16.7 A	48.7 A
2013	15.0 A	15.7 A	17.2 A	25.4 A	73.3 A
2014	19.0 E	20.0 E	22.0 E	29 E	90.0 E
2015					104.0 E

Earnings per Share
(EPS is operating earnings before non-recurring items)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2012	$10.1 A	$0.30 A	$0.32 A	$0.36 A	$1.25 A
2013	$0.46 A	$0.48 A	$0.58 A	$0.97 A	$2.46 A
2014	$0.57 A	$0.56 E	$0.66 E	$0.96 E	$2.83 E
2015					$3.30 E

Zacks Projected EPS Growth Rate - Next 5 Years %	**20**
N/A	**N/A**

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WHAT'S NEW

Despite a Record, Q1 Shows Slower Growth and Higher Taxes

On April 24, 2014, Silicom Ltd, reported financial results for its first quarter ended March 31, 2014. Revenues for the quarter were $19.0 million, up 26.4% from a year ago and in line with our estimates. Non-GAAP fully diluted EPS came in at $0.57 versus $0.46 the year before up 24% and beat street estimates by five cents.

Silicom reported record Q1 numbers, but investors slammed the stock. We believe that this may be because the company had blown away numbers for the past few quarters and this quarter was only a beat of $0.05 versus street estimates. In the December quarter, the EPS number was $0.24 ahead of estimates. Adding to this is the slower growth reported this quarter and estimates that the company may only grow revenues 20-25% and EPS 10-15%. The slowing growth in EPS is primarily due to an uphill tax rate from changes in the tax laws in both Israel and California. Last year Silicom showed 50% revenue growth and 60% earnings growth, with Q4 astonishing all, by its 52% revenue growth and 92% EPS growth. At its peak of $73, the stock was trading at 27 times 2014 consensus estimates.

While year over year revenues showed good progress, there was concern that sequentially, revenues fell 25% from $25 million in the fourth quarter of 2013. This was a steeper drop than the 10% drop in Q1 2013. By the nature of the business it is in, and the fact the company often holds inventory for customers, quarters should be expected to be lumpy and not very predictable. For example, once designed into a product, Silicom often doesn't know when exactly the customer will request delivery, as that depends on the customer's need as it depletes the inventory of a former product and moves to a new one, or launches an entirely new product.

Gross margin for the three months ended March 31, 2014, improved to 40.8% compared to 40.3% for the first quarter of 2013, hardily changed. However, gross margin rose sequentially from 39.9% for the three months ended December 31, 2013. All variations due to product mix.

Although total operating expenses increased year over year, they fell to 15.7% of revenues from 17.1% of revenues during the first quarter of 2013. The OEM model the company follows shows that it can continue to increase operating margins faster than revenues.

Operating income grew 37% year over year on a non-GAAP basis. However the biggest dent to EPS was a rise in the tax rate from 4.8% to 14.1% this year. As a result net income only increased 28% from a year ago.

Annual Dividend and Cash Balance

In mid-January 2013, the Company's Board of Directors adopted a policy for distributing dividends, subject to all applicable laws, where each year Silicom will distribute a dividend of up to 50% of its annual distributable profits. This year the company declared an annual dividend of $1.00 that was paid April 17, 2014 and used $7.2 million of the company's cash. Silicom ended the quarter with $55 million in cash (or $7.64 per share). After the dividend it would now be $47.7 million or $6.53 per share.

INVESTMENT THESIS

- The recent sell off, due to unwarranted expectations, gives investors an exceptional entry point to the stock at a 17 PE on a company with $6.52 per share in cash.
- SILC is a high margin, growing supplier to the networking industry that provides cost effective components to customer more cheaply than they can build in-house.
- They are designed into customer product making switching costs high and customers loyal.
- With over 20% net margins, high cash flow and long term growth over 20% we believe the stock to be undervalued on a PE-to-growth rate basis.
- The stock is a pure play in the quest for server efficiency for products being sold into high growth markets such as cloud and virtualization.
- The company's new sales venture into white label boards for the major social networks and cloud providers could give the company another large market opportunity and accelerate growth.

COMPANY DESCRIPTION

Silicom provides add-on boards for customers to improve the functionality of generic servers and network appliances. These customers, such as Dell, HP, Intel, Riverbed and SuperMicro, buy from Silicom as an alternative to designing and producing their own boards because it is cheaper. Even though the markets the customers serve are only growing 10-20%, Silicom has been able to grow sales faster than that due to its great value proposition to the customer. And earnings have grown even faster than sales due to economies of scale which are created by no incremental R&D or marketing costs when the same customers just order more of the same product.

Customers would rather spend their efforts on improving their products which yield them 75-80% gross margins than worry about a small component that can be bought cheaper than designing and building it themselves. Silicom's boards, which cost from between $100-$2000 each are components of a customer's product that can cost tens of thousands of dollars. While the in-house design capabilities of a customer is the main competition, third party competitors to Silicom are usually experts in one area and compete against one only of the company's products. No one competitor defines its mission as providing boards to boost performance of servers and network appliances across the board in all areas of possible enhancement. For example, Cavium focuses boards for encryption and compression, while Napatech sells network monitoring and time stamping.

Silicom's boards do one of two things for the customer's products:

- Add features
- Boost performance

Half of the company's revenues come from multi-port cards and bypass service adapters.

The multi-port cards simply add ports to a device. A standard server may come with one or two ports and a Silicom card can add upwards of eight more. Like adding a power strip to a wall outlet.



Bypass server adapters allow the server to keep running in case of a failure. For example, these can be used for devices that sit between a local area network (LAN) and wide area network (WAN) or the Internet. If something breaks, using a bypass server adapter will keep other operations running even if one server goes down.

Competitors for these products are primarily: Intel (INTC) (for non-bypass cards only), Interface Masters, Adlink, and Porter/Casewell.

The rest of revenues come from smart adapters and intelligent bypass switches.

Smart adapters are the fastest growing products at Silicom. They offload a specific task of the server to free CPU cycle time and improve performance. They come in a variety of flavors, each providing a specific function. Currently the company has products that do:

- Redirection
- Encryption and compression
- Time stamping
- Processor acceleration
- Virtualization

It is here that the company is adding new products with different functions. The most recent one added was the virtualization product. In December, Silicom secured a strategic design win from a first-time customer, one of the storage virtualization industry's strongest emerging players for this product. This is the company's first major design win with a storage virtualization leader. Management believes it will likely lead to additional business both with this customers and others.

End-user Products	Customers
WAN Optimization Appliances	Riverbed, Blue Coat, Cisco, Citrix, Silver Peak
Security Appliances	Checkpoint, Cisco, Juniper, Trend Micro, McAfee
Load Balancing Appliances	F5, Radware
Storage	EMC, Network Appliance
Telecom	Alcatel-Lucent
General Purpose Servers	Dell, HP, Intel, IBM, Fujitsu

OEM Business Model

95% of Silicom's sales go to OEMs. This creates significant operating leverage through reduced sales and marketing expenses, and gives the firm insight into new technologies. Once selected by a customer, Silicom has never been replaced by a competitor's product. Since Silicom has to be designed into a customer's product, the sales cycle is very long taking over a year for a decision. Fortunately then the average product will last three to four years before replacement during which time Silicom is the sole source supplier. There are very high switching costs. This somewhat mitigates the fact that the company has two very large customers, one of which comprised 33% of 2013 sales and the other another 10%. Between the two however they buy 10 different products.

Due to the economies of scale of the company, operating expenses as a percentage of sales have been falling each year going from 22.4% of sales in 2010 to 16.2% of sales in 2013 and 15.7% in the first quarter just reported.

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VALUATION

Due to an increased tax rate and slowing revenue growth predicted for this year, Silicom's stock has suffered multiple compression. The company's sales vary as customer's needs plateau and it often finds its sales growth a step function rather than linear. In 2013, the company had multiple factors working together to hit 50% growth, but historically sales have varied. In 2010, it grew 48%, in 2011 only 30% and in 2012, 23% before accelerating back up to 50% in 2013. This year could prove to be more in the 25% range. Adding to the compression is the uphill tax rate moving from 5% to 14%.

As a result we believe that investors should look beyond 2014 to 2015 when the tax rate will be flat and the company should again grow net income faster than earnings. With estimates of $3.30 for 2015, and long-term growth at 20% we believe the stock deserves a 20 multiple or $66 per share up from $47 today, and increase of 40%

PROJECTED INCOME STATEMENT

SILICOM

24-Apr-14	Non-GAAP	Non-GAAP	Non-GAAP	Non-GAAP	Non-GAAP	Non-GAAP	Non-GAAP	Non-GAAP	Non-GAAP					
	Dec Q4 12	**March Q1 13**	**June Q2 13**	**Sept Q3 13**	**Dec Q4 13**	**March Q1 14A**	**June Q2 14E**	**Sept Q3 14E**	**Dec Q4 14E**	**2011**	**2012**	**Non-GAAP 2013**	**Non-GAAP 2014E**	**Non-GAAP 2015E**
REVENUE														
Net Revenue	16.7	15.0	15.7	17.2	25.4	19.0	20.0	22.0	29.0	39.6	48.7	73.3	90.0	104.0
Yr-to-yr Gr.		49%	51.1%	49.0%	51.9%	26.4%	27.3%	27.9%	14.4%		23.0%	50.4%	22.8%	15.6%
						-0.250424								
OPERATING EXPENSES														
Cost of goods sold	10.4	9.0	9.4	10.2	15.2	11.2	11.9	13.1	17.5	22.4	28.8	43.8	53.7	62.0
Gross Margin	6.3	6.1	6.3	7.043	10.1	7.8	8.1	8.9	11.5	17.2	19.93	29.5	36.3	42.0
% of Sales	37.8%	40.3%	40.3%	40.9%	39.9%	40.8%	40.5%	40.5%	39.8%	43.4%	40.9%	40.3%	40.3%	40.4%
R&D	1.3	1.2	1.3	1.3	1.6	1.5	1.6	1.6	1.6	4.2	4.4	5.5	6.3	6.4
S&M	1.0	0.8	0.9	1.0	1.1	1.0	1.0	1.0	1.0	2.7	3.1	3.8	4.0	4.2
G&A	0.8	0.6	0.6	0.6	0.7	0.7	0.7	0.7	0.7	1.9	2.4	2.6	2.7	2.8
non-GAAP Adjustments	(0.4)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)	(0.2)		(0.7)	(0.6)	(0.5)	(0.5)
Tot Operating Exp.	2.7	2.567	2.7	2.8	3.2	3.0	3.2	3.2	3.1	8.7	9.1	11.3	12.4	13.0
		17.1%				15.7%								
Operating Income	3.6	3.487	3.646	4.245	6.9	4.8	4.9	5.8	8.4	8.5	10.8	18.3	23.9	29.0
Yr-to-yr Gr.				51.5%	92%	37%	35%	35%	22%		22.1%	24.9%	26.5%	27.9%
Interest Income	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.4	0.8	0.4	0.4	0.5
Pretax Income	3.7	3.6	3.7	4.3	7.0	4.9	4.8	5.7	8.3	8.9	11.5	18.7	24.3	29.5
						25.7%	24.2%	25.7%	28.6%		23.7%	25.5%	27.0%	28.4%
Taxes	0.3	0.3	0.3	0.2	0.2	0.7	0.7	0.8	1.2	0.7	0.9	0.9	3.4	4.3
Tax Rate	7.7%	9.3%	6.8%	3.5%	2.3%	14.1%	14.5%	14.5%	14.5%	7.5%	7.9%	4.8%	14.1%	14.5%
Net Income	3.4	3.3	3.5	4.2	6.8	4.2	4.1	4.8	7.1	8.2	10.6	17.8	20.9	25.2
Yr-to-yr Gr.					100%	28%	20%	15%	4%		28.9%	67.1%	17.4%	21.1%
Non-GAAP EPS-Basic	$0.49	$0.46	$0.49	$0.59	$0.96	$0.58	$0.58	$0.67	$0.99	$1.20	$1.53	$2.52	$2.90	$3.46
Non-GAAP EPS-Fully dil.	**$0.49**	**$0.46**	**$0.48**	**$0.58**	**$0.94**	**$0.57**	**$0.56**	**$0.66**	**$0.96**	**$1.18**	**$1.52**	**$2.46**	**$2.83**	**$3.30**
Yr-to-yr Gr.		53.4%	41.2%	53.3%	91.7%	24.1%	17.3%	12.7%	2.8%		29.4%	61.3%	15.0%	16.8%
Share Out	7.0	7.1	7.0	7.1	7.1	7.2	7.2	7.2	7.2	6.9	6.9	7.1	7.2	7.3
Fully diluted shares	7.0	7.1	7.2	7.2	7.3	7.3	7.4	7.4	7.4	7.0	7.0	7.2	7.4	7.6
											-0.4%	4.0%	1.7%	3.7%

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