Zacks Small-Cap Research

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Lisa Thompson
312-265-9154
lthompson@zacks.com

scr.zacks.com
10 S. Riverside Plaza, Suite 1600, Chicago, IL 60606

O_2Micro International Ltd (OIIM-NASDAQ)

OIIM: Undervalued Turnaround – Making Progress Toward Profits
OUTPERFORM

Current Recommendation	**Outperform**
Prior Recommendation	Neutral
Date of Last Change	11/12/2013
Current Price (04/29/14)	$3.48
Six- Month Target Price	**$5.00**

OUTLOOK

O_2Micro International is a fabless semiconductor firm that designs, develops and markets high performance integrated circuits primarily for power management and power saving applications for the computer, TV and LED lighting industries. The company trades at an enterprise value of only $25 m as it has $72 million in cash. It has implemented a massive restructuring by lowering costs and now has the challenge of growing revenues and returning to profitability. A return to growth should send the valuation of the company higher and in line with its peer group. New products in LED lighting and smartphones should rejuvenate growth.

SUMMARY DATA

52-Week High	**$3.85**
52-Week Low	**$2.71**
One-Year Return (%)	**1.75**
Beta	**1.39**
Average Daily Volume (sh)	**30,406**
Shares Outstanding (mil)	**28**
Market Capitalization ($mil)	**$97**
Short Interest Ratio (days)	**0.32**
Institutional Ownership (%)	**45**
Insider Ownership (%)	**8**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**-11.0**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**N/A**
P/E using 2013 Estimate	**N/A**
P/E using 2014 Estimate	**N/A**
Zacks Rank	**4**

Risk Level	**Above Average**
Type of Stock	**Small-Value**
Industry	**Elec Comp-Semic**

ZACKS ESTIMATES

Revenue
(Non-GAAP fully diluted EPS, in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2012	30 A	28 A	23 A	17 A	98 A
2013	17 A	19 A	19 A	18 A	74 A
2014	17 A	18 E	22 E	23 E	79 E
2015					85 E

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

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2012	$0.01 A	-$0.04 A	-$0.11 A	-$0.19 A	-$0.33 A
2013	-$0.15 A	-$0.13 A	-$0.14 A	-$0.11 A	-$0.53 A
2014	-$0.08 E	-$0.08 E	-$0.00 E	$0.01 E	-$0.15 E
2015					$0.00 E

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WHAT'S NEW

Q1 2014 Makes Good Progress to Profits

O2 Micro beat its lowered numbers today, especially on an earnings basis. The company reported revenue of $16.5 million at the upper end of its $15.5-16.5 million guidance. This is versus $17.3 million last March which is a decline of 5%, and is down sequentially from $19.1 in Q4 2013. The company had lowered guidance due to both continued weakness in PCs and notebook computers and TVs, and the delay of orders for product that was to go into LED lighting. This new product required the customer to redesign its circuit board layout, and this redesign was not completed when expected. This has been resolved and the product is now shipping.

The big surprise was the reduction in the loss for the company due to expense control, and the reported EPS beat street estimates by three cents. OIIM reported ($0.10) GAAP and ($0.08) non-GAAP, both fully diluted numbers. Both SG&A and R&D were lower than expected.

Operating expenses should remain steady and the company should be able to generate sequential revenue growth throughout the year that will bring it to profitability, perhaps as soon at the third quarter of this year. While keeping revenues the same we are raising our earnings estimates purely due to expense control. We are now looking for non-GAAP EPS of a loss of $0.16. We are hoping to see GAAP breakeven in the third quarter. For 2015, we are keeping revenues at $85 million, but moving non-GAAP earnings to breakeven for the year.

The company's sales for the quarter broke down as follows: consumer 45-55%, computer 20-30%, industrial 20-30%, and communications is less than 5%.

While the company sees lackluster computer and TV sales, it is doing well in power tools and appliances, LED, and a new emerging market of smartphones. There are two products that investor should keep an eye on and could bring some excitement to the story.

The first is a patented "free dimmable" LED light bulb. It has not yet been brought to market in the US but is for sale in Japan, China and Korea. This light bulb can be used in any lamp or fixture whether it has a dimmer switch or not. It instantly turns the light into a dimmable fixture. We think that this unique product could be a huge hit with consumers and we look forward to seeing how sales progress. The packaged LED market was $14 billion in 2013 and analysts Strategies Unlimited forecast the growth for LEDs in lighting to be 27% of CAGR from 2013 to 2018, driven mostly by an increased consumer confidence and continuously increasing sales of replacement lamps, down lights, industrial, commercial, and outdoor products.

The second product is a new lighting chip being sold to the smartphone market. The company has said that the chip has been designed into a Tier 1 smartphone vendor's product and expects shipments to start later in the year. The company calls it "novel" but is under NDA and unable to describe its unique features or what handset or vendor has bought the chip. The company hopes to be able to tell investors in the second quarter once the product is announced, but is unsure that even then, the customer will allow it to inform the public. The chip the vendor bought has been customized for them, but O2Micro is allowed to sell this product to other vendors. In 2013, one billion smartphones were sold, up 38% from the year before according to IDC. The top five vendors are Samsung (314 million), Apple (153 million), Huawei (49 million), LG (48 million) and Lenovo (46 million). This compares to 240 million TV sets sold worldwide and 190 million tablets. This much bigger addressable market should be a big winner for O2 Micro if they can gain market share with a unique product offering.

BACKGROUND

O2Micro, founded in 1995, is a Cayman Island-based fabless analog semiconductor manufacturer that fell on hard times in 2011 as the TV industry rapidly shifted from CCFL LCD TVs to LED TVs. O2Micro had dominant market share for chips that did the backlighting for these TVs and a business that represented a very large portion of sales for the company is now expected to generate less than $500,000 this year. The good news is it can now only go to zero. A company that peaked at $138 million in revenues in 2010 has now potentially troughed in 2013 at $74 million. In 2014, we are expecting revenues to once again increase to over $80 million for the total company. O2Micro's management was blindsided by this rapid decline and over the past five quarters has had to slash the work force by 30% and operating expenses over 40% as it works its way back to profitability. After three years of declining revenues, in the fourth quarter just reported, revenues actually grew 14% and the loss declined by $5.9 million from last year.

The company that remains is now over 50% backlighting chips but for LED TVs this time, as well at laptops and notebooks. This business they however do not dominate and must share the market with others resulting in lower sales than they had historically. Backlighting chips generally cost $0.30-50 cents and there is one per TV. Although they cater more to the Chinese and Japanese market, TVs overall are not expected to grow much more than 3% so at best we can hope for a stable business here going forward.

The next largest part (35%) of the business is Power and Battery chips. The power chips are used in notebooks and laptop computers and arrive in your Dell, HP, Sony or Lenovo computer via a Quanta or Compal motherboard. A quarter of this group's business is DC/DC converter chips that are in the brick on your charger cord. This business is not that exciting because of course notebooks and laptops are not that exciting. In this business the company competes with TI, Intersil, Maxim and Linear Technology. They are one of the top three suppliers for notebooks based on the Intel and AMD platforms. One bright spot in this group is 10% of group sales that sells to the portable tool and appliance business. These battery chips end up in Black & Decker power tools as well as Stanley, Makita and Bosch among others. Here business is expected to grow over 30%.

The final piece of the company, that could reach 15% of sales in 2014, is the rapid grower---General Lighting, which sells to the LED light bulb market. O2Micro makes a small chip that goes on a small board on the base of the bulb. In the US it sells to GE and Osram, and in Japan to Toshiba and Panasonic. This business should double this year and yield better than average margins.

VALUATION

As of the end of Q1 2014, company's balance sheet was very strong with $72 million in cash and no long-term debt. Thus the enterprise value for OIIM is $97 minus $72 million or $27 million.

Competitors	EV	TTM Sales	EV/Sales
ISIL	1360	575	2.4
MSCC	2910	984	3.0
MPWR	1180	238	5.0
CREE	5640	1530	3.7
MCHP	9140	1870	4.9
LLTC	8540	1350	6.3
MXIM	8900	2420	3.7
TXN	51020	12200	4.2
CRUS	897	772	1.2
Average			3.8

Looking at the Enterprise Value to Sales model the firm is trading well below its peers as shown is the chart above. Were we to use the average enterprise value to trailing twelve-month sales of 3.8 times and apply it to OIIM, we would calculate an enterprise value of $277 million. Adding to it $72 million in cash gives us a market cap of $349 million or $12.57 per share.

On an M&A Basis O2Micro Shares Possibly Worth Triple Current Value

O2Micro looks even more undervalued given the recent acquisition of competitor Supertex (SUPX-$32.98), at a $245 million enterprise value by Microchip (MCHP-$47.40). Supertex had sales of $17 million and $2.7 million in profits in its December quarter, and by comparison O2Micro generated $19 million that same quarter. Granted O2Micro is losing money and is cash flow negative at the moment, but it is possible, Q2 2014 could be the last cash flow negative quarter and profitability could be 4-6 quarters away. When it does turn cash flow positive, there could still $70 million in cash on the balance sheet or $2.50 per share.

All told, if the turnaround at O2Micro continues as planned the stock will appreciate to trade in line with it peers. However, at the same enterprise valuation to sales ratio as Supertex, which had $65 million in sales in 2013, O2Micro would be worth $279 plus $70 million in cash or a market value of $349 or $12.60 a share as an acquisition. While we do not believe O2Micro is for sale, at the current price of $3.66 per share a patient investor could be rewarded as investors see the value in the company as it potentially returns to historical profitability.

RISKS

- O_2Micro has exposure several slow growing and declining markets such as TVs and laptops. It is depending on LED lighting and other small businesses to give it revenue and margin growth.
- The firm is currently not at breakeven and is cash flow negative.

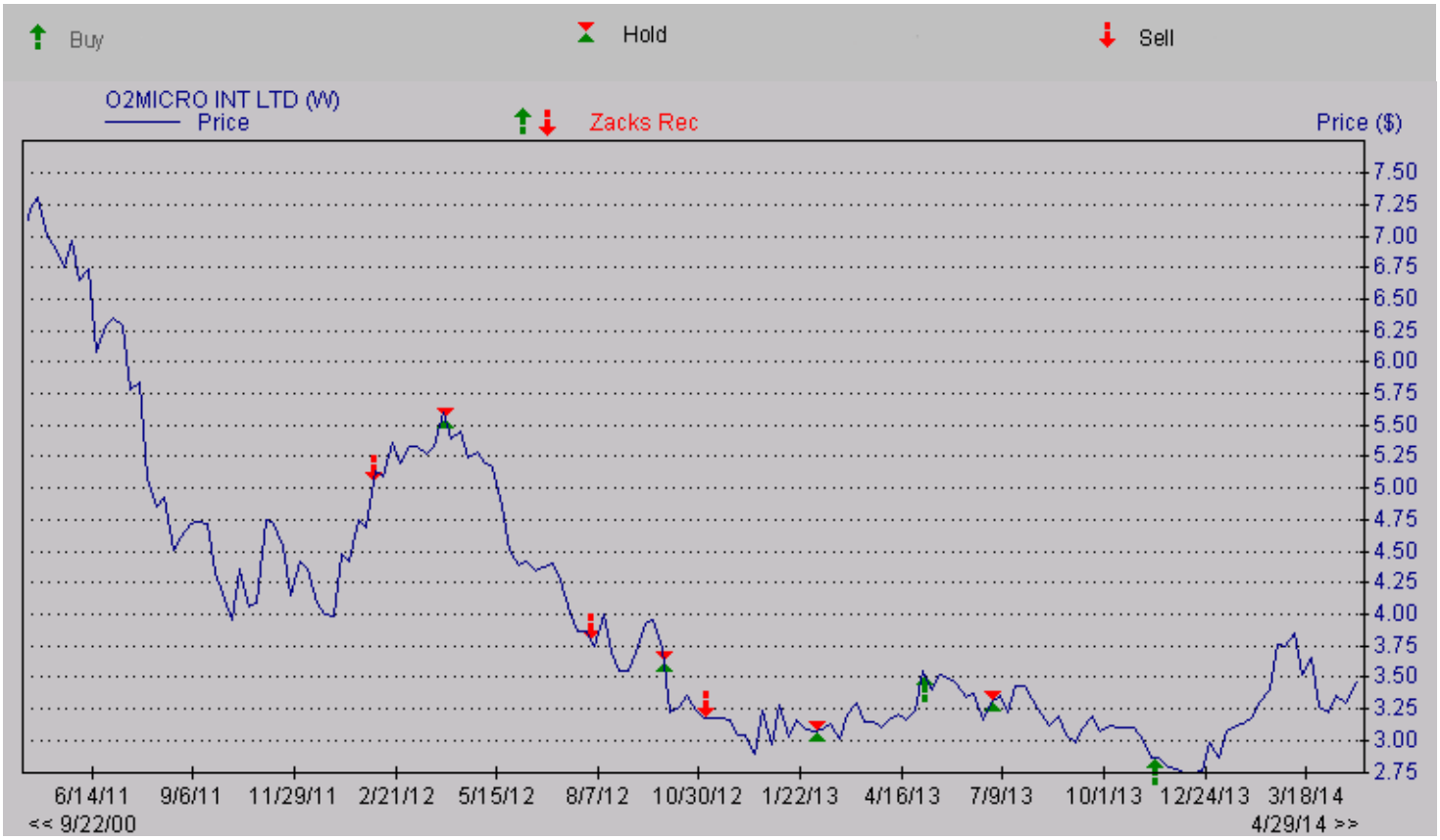
- Given the large number of patents litigation risk is a possibility as the company enforces its patents.

PROJECTED INCOME STATEMENT

O2 MICRO
30-Apr-14

	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	2012	2013	2014E	2015E
REVENUE													
Net Revenue	16.8	17.3	18.7	18.6	19.1	16.5	17.6	22.0	23.0	97.7	73.8	79.1	85.0
Yr-to-yr Gr.		-42%	-33.9%	-18.5%	14%	-5%	-6%	18%	20%		-24%	7%	7%
OPERATING EXPENSES													
Cost of goods sold	8.1	8.7	9.1	9.1	9.6	8.0	8.5	10.6	11.1	44.1	36.4	38.2	40.0
Gross Margin	8.7	8.7	9.6	9.6	9.5	8.5	9.1	11.4	11.9	53.6	37.4	40.8	45.0
% of Sales	51.6%	50.0%	51.2%	51.4%	49.9%	51.5%	51.5%	51.7%	51.8%	54.9%	50.7%	51.6%	52.9%
R&D	8.2	6.6	6.7	6.5	7.2	5.1	5.6	5.5	5.7	34.3	27.0	21.8	21.8
G&A	8.4	7.5	7.9	7.7	7.8	6.5	6.5	7.0	7.2	34.6	30.9	27.2	27.2
One-time expenses & Adj.	3.3					0.0	0.0	0.0	0.0	12.7		0.0	0.0
Tot Operating Exp.	20.0	14.1	14.6	14.2	15.0	11.6	12.1	12.5	12.9	81.6	57.9	49.1	49.0
Operating Income	(11.3)	(5.4)	(5.0)	(4.7)	(5.4)	(3.1)	(3.0)	(1.1)	(0.9)	(28.0)	(20.5)	(8.2)	(4.0)
						-42%							
Other Income	0.9	0.6	0.8	0.4	0.7	0.5	0.5	0.8	0.8	2.4	2.4	2.6	2.7
Pretax Income	(10.4)	(4.8)	(4.2)	(4.3)	(4.8)	(2.7)	(2.5)	(0.3)	(0.1)	(25.6)	(18.1)	(5.6)	(1.3)
						-16.1%	-14.3%	-1.5%	-0.6%	-26.2%	-24.5%	-7.1%	-1.5%
Taxes	0.3	0.2	0.2	0.2	0.3	0.3	0.3	0.3	0.3	1.1	1.0	1.1	1.0
Tax Rate	-2.6%	-4.8%	-5.3%	-5.8%	-6.1%	-9.6%	-9.9%	-85.9%	-198.5%	-4.3%	-5.5%	-18.7%	-77.3%
GAAP Net Income	(10.7)	(5.1)	(4.4)	(4.5)	(5.1)	(2.9)	(2.8)	(0.6)	(0.4)	(26.7)	(19.1)	(6.7)	(2.3)
GAAP EPS-Fully dil.	**($0.35)**	**($0.17)**	**($0.15)**	**($0.16)**	**($0.18)**	**($0.10)**	**($0.10)**	**($0.02)**	**($0.02)**	**($0.83)**	**($0.67)**	**($0.24)**	**($0.09)**
Non-GAAP	($0.19)	($0.15)	($0.13)	($0.14)	($0.11)	($0.08)	($0.08)	($0.00)	$0.01	($0.33)	($0.53)	($0.16)	($0.00)
Share Out	30.4	29.7	28.9	28.3	28.0	27.8	27.5	27.3	27.0	31.0	28.7	27.4	26.4
Fully diluted shares	30.4	29.7	28.9	28.3	28.0	27.8	27.5	27.3	27.0	31.0	28.7	27.4	26.4

HISTORICAL ZACKS RECOMMENDATIONS



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