Zacks Small-Cap Research

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O_2Micro International Ltd (OIIM-NASDAQ)

OIIM: Activists Buy Stock to Accelerate Change

OUTPERFORM

Current Recommendation	**Outperform**
Prior Recommendation	Neutral
Date of Last Change	11/12/2013
Current Price (2/03/2015)	$2.45
12- 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 LED lighting industry. The company trades at a $2.8 million enterprise value, as it has $63 m in cash. It also has $23 m in real estate and $10-20 m in investments in other companies. Shareholder activists have taken notice and we hope for this to spur change and increase shareholder value.

SUMMARY DATA

52-Week High	**$3.89**
52-Week Low	**$1.90**
One-Year Return (%)	**-24.15**
Beta	**1.36**
Average Daily Volume (sh)	**40,853**
Shares Outstanding (mil)	**27**
Market Capitalization ($mil)	**$66**
Short Interest Ratio (days)	**0.46**
Institutional Ownership (%)	**36**
Insider Ownership (%)	**8**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**-16.3**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**N/A**
P/E using 2015 Estimate	**N/A**
P/E using 2016 Estimate	**N/A**
Zacks Rank	**2**

Risk Level	**Above Average**
Type of Stock	**Small-Value**
Industry	**Elec Comp-Semis**
Zacks Rank in Industry	**6 of 48**

ZACKS ESTIMATES

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

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2013	17 A	19 A	19 A	19 A	74 A
2014	17 A	17 A	15 A	14 A	64 A
2015	13 E	14 E	15 E	17 E	60 E
2016					66 E

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

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2013	-$0.15 A	-$0.13 A	-$0.14 A	-$0.11 A	-$0.53 A
2014	-$0.08 A	-$0.10 A	-$0.09 A	-$0.09 A	-$0.36 A
2015	-$0.10 E	-$0.09 E	-$0.06 E	-$0.02 E	-$0.27 E
2016					-$0.24 E

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Lone Star Posts Letter to Encourage Management to Accelerate Change

While the company reported earnings for the quarter in line with previous guidance (despite headline that wrongly declared an earnings shortfall), the true impetus to the stock price as of late has been the accumulation of stock by a prominent activist hedge fund Lone Star Value Management. In its February 2nd filing, it indicated it now has 6.3% of the outstanding and has been buying at prices between $2.16 and $2.51 in the past 60 days. We believe this has put a floor on the stock price.

In a letter to O2 shareholders, the company was urged to allow shareholder participation on the board, change the board composition with new sets of eyes, make meaningful changes to the company's cost structure to stop the cash burn, and capitalize on the company's patent portfolio.

Lone Star proceeded to mathematically show the company's underperformance and then gave its liquidating value that it believed was $118 million or $4.35 per share.

Table 1. O2Micro Ownership

Name	Shares Held Outstanding	Position Value	% of Total
DNB Asset Management AS	2.7	$6.8	9.6%
Renaissance Technologies Corp.	1.8	$4.6	6.5%
Lone Star Value Investors	**1.7**	$4.4	**6.3%**
Grandeur Peak Global Advisors	1.6	$4.1	5.8%
Robeco Investment Management	1.1	$2.8	4.0%
Fidelity Management & Research	1.0	$2.5	3.5%
Potomac Capital Management	0.7	$1.7	2.5%
Eidelman Virant Capital	0.7	$1.7	2.4%
Brightfield Capital Management	0.7	$1.7	2.3%
Credit Suisse Securities (USA)	0.5	$1.3	1.9%
True Bearing Asset Management	0.5	$1.2	1.8%
Other	14.9	$37.8	53.5%
Total	27.8		

O2Micro would not comment on the letter or its discussion with Lone Star when asked on the earnings conference call. Management did say they would consider any suggestions made by shareholders and requested they were submitted in writing for the board to discuss.

Non-GAAP Q4 Earnings Come in As Expected But One-Time Charges Hurt GAAP Numbers

O2Micro revenues for the fourth quarter came in a few hundred thousand short of our estimate, but within the company's guidance at $14.3 million, down 25% from the year ago and 7% sequentially. Other than in Q2 last year, we continue to see the downward slide in revenues, due primarily to the decline in the notebook market. Gross margins came in at 51% slightly down from Q3's 51.8% but higher than last year's 48%.

Expenses were up only due to one-time charges; something wire services failed to notice when they said the company missed its EPS numbers. If we take out the one-time $3 million charges for layoffs, expenses were down sequentially as well as year over year. Thus the GAAP loss of $0.23 per share, was actually a $0.09 non-GAAP loss, one cent better we were expecting.

Despite the new round of cost cutting, the company has lowered its cash flow breakeven only to $17-18 million and its earnings breakeven to $20-21 million. Not nearly enough for a company that projects revenues at $12.9 to $14.3 million next quarter, and evidence of the point Lone Star is making that the company has not yet right-sized its business by these timid steps.

Q1 Results Could be Sequentially Down

Since Q1 is typically a weak quarter for the industry, guidance by management was for flat to down revenues. As expenses are still well above breakeven, we expect earnings in Q1 to be down sequentially and down year over year at a non-GAAP loss of $0.10 per share versus a loss of $0.08 last year. The unknowns, which were significant this quarter, are whether the company will sell more real estate, and what currency effects will be. These two factors, $468,000 and $415,000 respectively can swing numbers. The property sale alone was a two-cent difference, and we believe, should have been considered a one-time gain and taken out of non-GAAP. O2Micro has only sold half of its real estate in Hsinchu, Taiwan and plans to sell the remaining portion during the course of 2015. This half was sold for $1.96 million, resulting in an investment gain of $458,000.

2015 Estimates

For the year we are looking for the company to continue to cut losses as it has down for the past three years but are not expecting up revenues for the year unless the second half kicks in with even higher growth. Even more important is stemming the cash losses, rather than growing revenues and we hope management sacrifices one for the other. In 2015, we are expecting revenues of $60 million, and a non-GAAP loss of $0.27 more than the $0.20 previously forecasted. But at this point what will move the stock is any action by activists to accelerate cost cutting or inducing the sale of the company. Either of these actions should greatly increase shareholders value.

VALUATION

Balance Sheet Assets are Still Worth More than $100 Million

To update our valuation, the company now has an enterprise value of $2.8 million, or $2.45 per share time's 26.7 million shares, minus $62.6 million in cash. An improvement over the negative number calculated just last quarter. Additionally, the company still owns two buildings: one building is in Santa Clara, one in Taiwan and half of one in Shanghai. Their market value should be around $23 million. As of December 31, 2014 pricing, there is another $14.7 million in long term investments, which are primarily holdings in two, companies X-FAB Silicon Foundries and Sigurd Microelectronics (Cayman) Co., Ltd. In Q3 2014, the quarter the company sold some of its holdings in public company Etrend and plans to sell the rest in 2015.

In updating comparables, we see the comparable valuations have increased 14% from 3.5 times to 4.0 times.

Were we to use the average enterprise value to trailing twelve-month sales of 4.0 times and apply it to OIIM's current $53 revenue run rate, we would calculate an enterprise value of $213 million. Adding to it $63 million in cash gives us a market cap of $276 million or **$10.34 per share**.

Competitors	EV	TTM Sales	EV/Sales
ISIL	$1,760	$563	3.1
MSCC	3,330	1,190	2.8
MPWR	1,650	270	6.1
CREE	3,330	1,680	2.0
MCHP	9,410	2,100	4.5
LLTC	10,170	1,440	7.1
MXIM	9,250	2,400	3.9
TXN	58,080	13,040	4.5
CRUS	1,760	811	2.2
Average			4.0

RISKS

- O_2Micro has exposure several slow growing and declining markets such as TVs and notebooks. It is depending on General LED lighting and other battery management to give it revenue and margin growth.
- It may be difficult for the company to capture market share in smartphones and tablets as a new entrant in an established field.
- It recently lost a large customer and will need to regain trust in the industry to recapture market share.
- 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

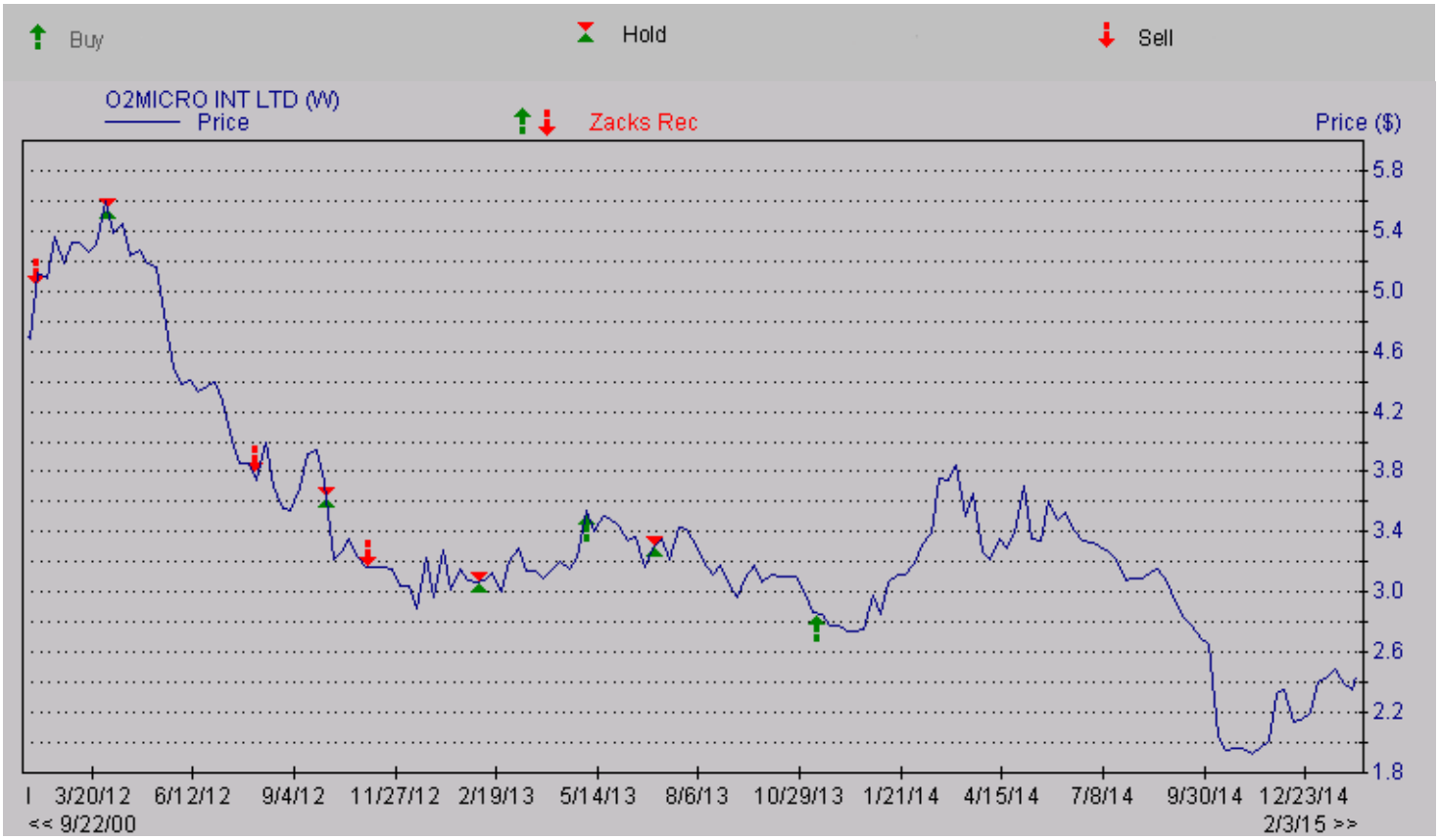
O2 MICRO
4-Feb-15

	March Q1 14A	June Q2 14A	Sept Q3 14A	Dec Q4 14A	March Q1 15E	June Q2 15E	Sept Q3 15E	Dec Q4 15E	2012	2013	2014	2015E	2016E
REVENUE													
Net Revenue	16.5	17.4	15.4	14.3	13.3	14.0	15.4	17.3	97.7	73.8	63.6	60.0	66.0
Yr-to-yr Gr.	-5%	-7%	-17%	-25%	-19%	-20%	0%	21%	-21%	-24%	-14%	-6%	10%
OPERATING EXPENSES													
Cost of goods sold	8.0	8.4	7.4	7.0	6.5	6.9	7.5	8.5	44.1	36.4	30.9	29.4	32.0
Gross Margin	8.5	9.0	8.0	7.3	6.8	7.1	7.8	8.8	53.6	37.4	32.7	30.6	34.0
% of Sales	51.5%	51.5%	51.8%	51.0%	51.0%	51.0%	51.0%	51.0%	54.9%	50.7%	51.5%	51.0%	51.5%
R&D	5.1	5.8	5.5	5.6	5.4	5.4	5.4	5.4	34.3	27.0	21.9	21.4	21.0
SG&A	6.5	6.3	6.0	5.8	5.5	5.5	5.5	5.5	34.6	30.9	24.7	22.1	22.0
One-time expenses & Adj.	0.0	0.0	0.0	3.0	0.0	0.0	0.0	0.0	12.7		3.0	0.0	0.0
Tot Operating Exp.	11.6	12.1	11.5	14.4	10.9	10.9	10.9	10.9	81.6	57.9	46.6	43.5	43.0
							0%						
Operating Income	(3.1)	(3.1)	(3.5)	(7.1)	(4.1)	(3.7)	(3.0)	(2.1)	(28.0)	(20.5)	(13.9)	(12.9)	(9.0)
Other Income	0.5	0.1	0.9	1.5	1.1	1.3	1.3	1.1	2.4	2.4	2.9	4.7	2.0
Pretax Income	(2.7)	(3.0)	(2.7)	(5.6)	(3.0)	(2.5)	(1.8)	(1.0)	(25.6)	(18.1)	(10.9)	(8.2)	(7.0)
	-16.1%	-17.0%	-17.5%	-39.1%	-22.6%	-17.7%	-11.5%	-5.7%	-26.2%	-24.5%	-17.2%	-13.7%	-10.6%
Taxes	0.3	0.2	0.3	0.5	0.3	0.2	0.2	0.1	1.1	1.0	1.2	0.7	0.7
Tax Rate	-9.6%	-7.7%	-9.3%	-8.0%	-8.5%	-9.3%	-9.3%	-9.3%	-4.3%	-5.5%	-10.8%	-9.0%	-9.3%
GAAP Net Income	(2.9)	(3.2)	(2.9)	(6.0)	(3.3)	(2.7)	(1.9)	(1.1)	(26.7)	(19.1)	(12.1)	(9.0)	(7.7)
GAAP EPS-Fully dil.	($0.10)	($0.12)	($0.11)	($0.23)	($0.12)	($0.10)	($0.08)	($0.04)	($0.83)	($0.67)	($0.56)	($0.35)	($0.32)
Non-GAAP	**($0.08)**	**($0.10)**	**($0.09)**	**($0.09)**	**($0.10)**	**($0.09)**	**($0.06)**	**($0.02)**	**($0.33)**	**($0.53)**	**($0.36)**	**($0.27)**	**($0.24)**
Share Out	27.8	27.4	27.2	26.7	26.2	25.7	25.2	24.8	31.0	28.7	27.2	25.5	23.7
Fully diluted shares	27.8	27.4	27.2	26.7	26.7	25.7	25.2	24.8	31.0	28.7	27.2	25.6	23.7
Yr-to-yr Gr.	-0.7%	-1.4%	-0.7%	-1.8%	-4%	-6%	-7%	-7%		-7.5%	-5.1%	-6.0%	-7.5%

BALANCE SHEET

In Thousands $	Dec 31, 2014	Sept 30, 2014	June 30, 2014	Dec. 31, 2013	Dec-Dec % Change	Dec. 31, 2012
CURRENT ASSETS						
Cash and cash equivalents	$41,069	$33,753	$19,641	$42,293	-3%	$27,898
Restricted cash	164	171	174	173	-5%	177
Short-term investments	21,481	31,177	46,549	33,606	-36%	69,427
Accounts receivable, net	6,789	8,251	10,161	10,024	-32%	8,773
Inventories	8,642	10,187	9,584	7,217	20%	7,917
Prepaid expenses and other current assets	1,308	1,409	1,461	1,437	-9%	1,957
Total current assets	**79,453**	**84,948**	**87,570**	**94,750**	-16%	**116,149**
LONG-TERM INVESTMENTS	14,754	15,300	16,175	16,121	-8%	15,530
PROPERTY AND EQUIPMENT, NET	19,363	21,448	22,065	23,039	-16%	26,142
OTHER ASSETS						
Restricted assets						10,000
Intangible assets, net						31
Other assets	3,168	3,449	3,697	3,509	-10%	3,474
Total other assets	3,168	3,449	3,697	3,509	-10%	13,505
TOTAL ASSETS	116,738	125,145	129,507	137,419	-15%	171,326
CURRENT LIABILITIES						
Notes and accounts payable	2,131	3,950	4,690	4,169	-49%	3,756
Income tax payable	650	392	349	238	173%	362
Accrued expenses and other current liabilities	6,049	5,340	4,779	5,353	13%	6,577
Total current liabilities	8,830	9,682	9,818	9,760	-10%	10,695
OTHER LONG-TERM LIABILITIES						
Accrued pension liabilities	333	375	385	391	-15%	708
Other liabilities	309	396	516	658	-53%	9,551
Total long-term liabilities	642	771	901	1,049	-39%	10,259
Total liabilities	9,472	10,453	10,719	10,809	-12%	20,954
SHAREHOLDERS EQUITY						
Preference shares at $0.00002 par value per share; Authorized 250,000,000 shares;	33	33	33	33	0%	33
Additional paid-in capital	141,229	140,793	140,272	140,198	1%	138,793
Retained earnings (accumulated deficits)	(17,291)	(11,282)	(8,341)	(2,234)	674%	16,865
Accumulated other comprehensive income	6,768	7,565	8,305	8,512	-20%	7,865
Treasury stock 269,042,350 and 162,072,500 shares as of Dec 31, 2013 and 2012, respectively	(23,473)	(22,417)	(21,481)	(19,899)	18%	-13,184
Total shareholders equity	107,266	114,692	118,788	126,610	-15%	150,372
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$116,738	$125,145	$129,507	$137,419	-15%	$171,326
Cash	$62,550	$64,930	$66,190	$75,899	-18%	$97,325
Current Ratio	9.0	8.8	8.9	9.7	-7%	10.9
Quick Ratio	8.0	7.7	7.9	9.0	-11%	10.1

HISTORICAL ZACKS RECOMMENDATIONS



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